MEEZANBANK'S GUIDE TO

ISLAMIC BANKING

Dr. Muhammad Imran Ashraf Usmani

MEEZAN BANK

The Premier Islamic Bank

DARUL ISHAAT
KARACHI PAKISTAN

Meezan Bank's Guide to Islamic Banking

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Islamic Banking

Written by

Dr. Muhammad Imran Ashraf Usmani

Ph. . Islamic Finance

Assistance in translation, editing and compilation by

Zeenat Zubairi

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PREFACE

P R E F A C E

نحمده و نصلى على رسوله الكريم

Today the world economic system, that is based on interest, has resulted in concentrating the wealth in the hands of selected few creating monopolies and widening the gap between the rich and the poor. In contrast Islam encourages circulation of wealth and regards its role as important to an economy as the flow of blood to our human body. Just as clotting of blood paralyzes human body, concentration of wealth paralyzes economy. The fact is that today 10 richest men in the world have more wealth than 48 poorest countries of the world. Millions are malnourished, lack access to safe water, cannot read or write, in short the quality of life has decayed and the graph continues to go down.

Economic justice requires a viable economic system supported by an efficient banking system. Interest based banking has proved to be inefficient as it fails to equitably distribute wealth which is necessary for the well being of mankind. On the other hand Islamic banking is efficient and ensures equitable distribution of wealth thus laying foundation for an inflation free economy and socially responsible banking.

Last few years have witnessed a dramatic increase in Islamic banking the world over. At least two hundred Islamic banks and financial institutions have been set up. According to a research report, the growth rate of these institutions is 15% per annum. At least two hundred billion US dollars are invested in this system. Many multinational banks have opened Islamic banking windows or subsidiary of Islamic banking. The information on Islamic banking is also available

in books, CDs and websites in the form of database, multimedia directories, and encyclopedias.

On the Shariah side, there are a number of scholars on Shariah boards of Islamic banks who have compiled *Fatwas*, resolutions and articles on various issues of Islamic banking and finance. In Pakistan, we have at least two very comprehensive reports on Islamic banking system produced by Islamic Ideological Council 1980 and the Commission for Islamization of Economy in 1992. Therefore Islamic banking is not a utopian idea. There is a need to develop insight, educate and train the bankers in the Islamic economic and banking system. Without having a deep understanding of the principles of Islamic banking, it is difficult to offer its products and services that conform to the true spirit of Islamic shariah.

In July 1998, I joined Meezan Bank as a Shariah Consultant with a vision to make the bank a model Islamic bank. With the encouragement of Mr. Irfan Siddiqui, our Chief Executive Officer, I carried a comprehensive training course for the staff of the bank. The series of lectures included topics such as Islamic economic system, Riba, its prohibition and classifications, Islamic contract, Islamic modes of financing and their applications, banking in Islam and Islamic Investments. Various handouts related to the lectures were distributed to the participants of the course that were mainly taken from my thesis on Musharakah, Mudarabah and Kitab-ul-Buyoo (rules of Islamic Sale relevant to Islamic banking and finance). Some handouts were adapted from the books and articles written by my respected father Maulana Mohammad Taqi Usmani. Our participants of the course were of the view that these handouts and notes from my lectures should be organized, edited and properly translated into English to develop a proper Guide on Islamic Banking.

I am grateful to all team members who helped me prepare this Guide and gave me some very good suggestions. I am

especially grateful to our colleague Mrs. Zeenat Zubairi for assisting me tirelessly in the translation work, editing and compilation of this project. I am also grateful to Mr. Irfan Siddiqui and Mr. Pervez Said for not only participating in these lectures actively from inception but also encouraging us in the preparation of this Guide.

We are Alhamdollillah running this course successfully at The Institute of Business Administration, (IBA) Karachi. We have already trained two batches and now the third batch is getting its formal education on Islamic banking.

In the end I pray to Allah Subhanahu Wa Tallah to accept our efforts in His cause, and give us the guidance and ability for such humble efforts in future as well to free the world from Riba and revive Islamic values all over the world. Ameen.

Imran Usmani
10 Moharram 1423

SECTION I

INTRODUCTION TO ISLAMIC ECONOMIC SYSTEM

1

INTRODUCTION TO ISLAMIC ECONOMIC SYSTEM

Introduction

One of the forms of capitalism, which has been flourishing in non-Islamic societies, is the interest-based investment. There are normally two participants in such transactions. One is the Investor who provides capital on loan and the other Manager who runs the business. The investor has no concern whether the business runs into profit or loss, he automatically gets an interest (*Riba*) in both outcomes at a fixed rate on his capital. Islam prohibits this kind of trading and the Holy Prophet ﷺ enforced the ruling, not in the form of some moral teaching, but as the law of land.

It is very important to know the definition and forbiddance of *Riba* and the injunctions relating to its unlawfulness from different angles. On the one hand, there are severe warnings of the *Qur'an* and *Sunnah* and on the other, it has been taken today as an integral part of the world economy. The desired liberation from it seems to be infested with difficulties. The problem is very detail oriented and has to be taken up in all possible aspects.

First of all we have to deliberate into the correct interpretation of the Quranic verses on *Riba* and what has been said in authentic *ahadith* and then determine what *Riba* is in the terminology of the *Quran* and *Sunnah*, what transaction

it covers, what is the underlying wisdom behind its prohibition and what sort of harm it brings to society. We will start from looking at the economic philosophy of Islam vis-à-vis interest.

The economic philosophy of Islam Vis-a-Vis Interest

The economic philosophy of Islam has no concept of *Riba* because according to Islam, *Riba* is that curse in society, which accumulates money around handful of people, and it results inevitably in creating monopolies, opening doors for selfishness, greed, injustice and oppression. Deceit and fraud prospers in the world of trade and business. Islam, on the other hand, primarily encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, social fairness and justice. Due to this reason, Islam renders *Riba* as absolutely *haram* and strictly prohibits all types of interest based transactions.

The prohibition of *Riba* in the light of economic philosophy of Islam can be explained with the cost of distribution of wealth in a society.

Distribution of wealth

The distribution of wealth is one of the most important and most controversial subjects concerning the economic life of man, which has given birth to global revolutions in today's world, and has affected every sphere of human activity from international politics down to the private life of the individuals. For many a century now, the question has been the center not only of fervent debates, oral and written both, but also of armed conflicts. The fact, however, is that whatever has been said on the subject without seeking guidance from Divine Revelation and relying merely on human reason, has had the sole and inevitable result of making the confusion worse confounded.

Islamic perspective of distribution of wealth
In this chapter, we propose to state as clearly and briefly as possible the point of view of Islam in this matter, such as we have been able to deduce from the Holy Qur'an, the *Sunnah* and the writings of the "Thinkers" on distribution of wealth in the Islamic context.

Before explaining the point, it seems to be imperative to clarify certain basic principles which one can derive from the *Quran*, and which distinguish the Islamic point of view in economics from non-Islamic systems of economy.

1. The importance of the economic goals
No doubt, Islam is opposed to monasticism, and views the economic activities of man quite lawful, meritorious, and some times even obligatory and necessary. It approves of the economic progress of man, and considers lawful or righteous livelihood an obligation of the secondary order. Notwithstanding all this, it is no less a truth that it does not consider "economic activity" to be the basic problem of man, nor does it view economic progress as the be-all and end-all of human life.

Many misunderstandings about Islamic economics arise just from confusion between the two facts of considering economics as the ultimate goal of life and considering it as a necessity in order to have a prosperous life through lawful means. Even common sense can suffice to show that the fact of an activity being lawful or meritorious or necessary separate from it being the ultimate goal of human life and the center of thought and action. It is, therefore, very essential to make the distinction as clear as possible at the very outset. In fact, the profound, basic and far-reaching difference between Islamic economics and materialistic economics is just this:

According to materialistic economics:

"*Livelihood is the fundamental problem of man and economic*

developments are the ultimate end of human life"

While according to Islamic economics:

"Livelihood may be necessary and indispensable, but cannot be the true purpose of human life"

So, while we find in the Holy Quran the disapproval of monasticism and the order to: "Seek the benevolence of Allah." At the same time we find in the *Quran* to restrain from the temptations or delusion for worldly life. And all these things in their totality have been designated as "*Ad-Dunya*" ("the mean") — a term which, in its literal sense, does not have a pleasant connotation.

Apparently one might feel that the two commands are contradictory, but the fact is that according to the Quranic view, all the means of livelihood are no more than just stages on man's journey, and his final destination lies beyond them. That destination is the sublimity of character and conduct, and, consequently, the felicity of the other world. The real problem of man and the fundamental purpose of his life is the attainment of these-two goals. But one cannot attain them without traversing the path of this world. So, all those things too which are necessary for his worldly life, become essential for man. It comes to mean that so long as the means of livelihood are being used only as a path leading towards the final destination, they are the benevolence of Allah, but as soon as man gets lost in the mazes of this pathway and allows himself to forget his real destination, the very same means of livelihood turn into an "temptation, or delusion" into a "trial": *"And know that your possessions and your children are but a trial"* (8:28).

The Holy Quran has enunciated this basic truth very precisely in a brief verse:

"*Seek the other world by means of what Allah has bestowed upon*

you" (28:77).

This principle has been stated in several other verses too. This attitude of the Holy Quran towards "the economic activity" of man and its two aspects would be very helpful in solving problems of man of Islamic economics.

2. The real nature of wealth and property

The other fundamental principle, which can help to solve the problem of the distribution of wealth, is the concept of "wealth" in Islam. According to the illustration of the Holy Quran "wealth" in all its possible forms is a thing created by Allah, and is, in principle His "property". Allah delegates the right of property over a thing, which accrues to man, to Him. The Holy Quran explicitly says:

"*Give to them from the property of Allah which He has bestowed upon* you." *(24:33).*

According to *Quran* the reason for this philosophy is that all a man can do is invest his labor into the process of production. But Allah alone, and no one else, can cause this endeavor to be fruitful and actually productive. Man can do no more than sow the seed in the soil, but to bring out a seedling from the seed and make the seedling grow into a tree is the work of some one other than man. The Holy Quran says:

"*Have you considered what you till? Is it you yourselves who make it grow, or is it We who make it grow?*" And in another verse:

"*Have they not seen that, among the things made by our own hands. We have created cattle for them, and thus they acquired the right of property over them?" (36:71)*

All these verses throw ample light on the fundamental point that "wealth", no matter what its form, is in principle "the property of Allah", and it is He who has bestowed upon man the right to exploit it. So Allah has the right to demand that

man should subordinate his exploitation of this wealth to the commandments of Allah.

Thus, man has the "right of property" over the things he exploits, but this right is not absolute or arbitrary or boundless, it carries along with it certain limitations and restrictions, which have been imposed by the real owner of the 'wealth'. We must spend it where He has commanded it to be spent, and refrain from spending where He has forbidden. This point has been clarified more explicitly in the following verse:

*"Seek the other world by means of what Allah has bestowed upon you, and do not be negligent about your share in this world. And do good as Allah has done good to you, and do not seek to spread disorder on the earth." (*28:77)

This verse fully explains the Islamic point of view on the question of property. It places the following guidelines before us:

(1) Whatever wealth man does possess has been received from Allah.

(2) Man has to use it in such a way that his ultimate purpose should be the other world

(3) Since wealth has been received from Allah, its exploitation by man must necessarily be subject to the commandment of Allah.

(4) Now, the Divine Commandment has taken two forms:-

a) Allah may command man to convey a specified production of "Wealth" to another man. This Commandment must be obeyed, because Allah has done good to you, so He may command you to do good to others - "*do good as Allah has done good to you*".

b) He may forbid you to use this "wealth" in a specified way. He has every right to do so because He cannot allow you to use "wealth" in a way which is likely to produce collective ills or to spread disorder on the earth.

This is what distinguishes the Islamic point of view on the question of property from the Capitalist and Socialist points of view both. Since the mental background of Capitalism is, theoretically or practically, materialistic, it gives man the unconditional and absolute right of property over his wealth, and allows him to employ it, as he likes. But the Holy Quran has adopted an attitude of disapprobation towards this theory of property, in quoting the words of the nation of Hazrat Shu'aib. They used to say:

"*Does your way of prayer command you that we should forsake what our forefathers worshipped, or leave off doing what we like with our own property?*" *(11:87)*

These people used to consider their property as really theirs or "Our property", and hence the claim of "doing what we like" was the necessary conclusion of their position. But the Holy Quran has, in the chapter "Light" substituted the term "the property of Allah" for the expression "Our possessions", and has thus struck a blow at the very root of the Capitalistic way of thinking. But at the same time, by adding the qualification "what Allah has bestowed upon you", it has cut the roots of Socialism as well, which starts by denying man's right to private property. Similarly, ("thus they acquired the right property over them") - a verse in the Chapter "Seen", explicitly affirms the right to private property as a gift from Allah.

Difference between Islam, Capitalism and Socialism

Now we are in a position to draw clear boundary lines that separate Islam, Capitalism and Socialism from one another: -

Capitalism affirms an absolute and unconditional right to private property.

Socialism totally denies the right to private property.

But the truth lies between these two extremes - that is ***Islam*** admits the right to private property but does not consider it to be an absolute and unconditional right that is bound to cause "disorder on the earth”.

2

FACTORS OF PRODUCTION IN ISLAM

THE CAPITALIST VIEW

In order to understand the Islamic point of view fully, it would be better to have a look at the system of the distribution of wealth that is obtained under the capitalist economy. This theory can be briefly stated like this: wealth should be distributed only over those who have taken a part in producing it, and who are described in the terminology of economics as the factors of production. According to the Capitalistic economics, these factors are four:-

1. **Capital**: which has been defined as "the produced means of production" - that is to say, a commodity which has already undergone one process of human production, and is again being used as a means of another process of production.
2. **Labour**: that is to say, any exertion on the part of man.
3. **Land**: which has been defined as "natural resources" (that is to say, those things which are being used as means of production without having previously undergone any process of human production).
4. **Entrepreneur, or Organization:** The fourth factor that brings together the other three factors, exploits them and bears the risk of profit and loss in production.

Under the Capitalist economy, the wealth produced by the co-operation of these four factors is distributed over these very four factors as follows: one share is given to Capital in the shape of interest, the second share to Labor in the shape

of wages, the third share to Land in the shape of rent (or revenue), and the fourth share (or the residue) is reserved for the Entrepreneur in the shape of profit.

THE SOCIALIST VIEW

On the other hand under the Socialist economy, capital and land instead of being private property, are considered to be national or collective property. So, the question of interest or rent (or revenue) does not arise at all under the philosophy of this system. Under the Socialist system, the entrepreneur too is not an individual but the state itself. So profit as well is out of the question here - at least in theory. Now, there remains only one factor namely labor. And labor alone is considered to have a right to wealth under the Socialist system, which it gets in the shape of "Wages".

THE ISLAMIC VIEW

The Islamic system of the distribution wealth is different from both. From the Islamic point of view, there are two kinds of people who have a right to wealth:

1. Those who have a primary right that is to say, those who have a right to wealth directly in consequence of participation in the process of production. In other words, it is those very "factors of production" which have taken a part in the process of producing some kind of wealth.
2. Those who have a secondary right, that is to say, those who have not taken a direct part in the process of production, but it has been enjoined upon the producers to make them co-sharers in their wealth.

Let it be made clear that we are here concerned with the basic philosophy or theory of socialism, and not with its present practice, for the actual practice in socialist countries is quite different from this theory.

ISLAMIC THEORY

Those who have a primary right to wealth

As indicated above, the primary right to wealth is enjoyed by "the factors of production." But "the factors of production" are not specified or technically defined, nor is their share in wealth determined in exactly the same way as is done under the Capitalist system of economy. In fact, the two ways are quite distinct. From the Islamic point of view, the actual factors of production are three instead of being four:-

1. **Capital**: That is, those means of production which cannot be used in the process of production until and unless during this process they are either wholly consumed or completely altered in form, and which, therefore, cannot be let or leased (for example, liquid money or food stuff etc.)
2. **Land**: That is, those means of production, which are so, used in the process of production that their original and external form remains unaltered, and which can hence be let or leased (for example, lands, houses, machines etc.).
3. **Labor**: That is, human exertion, whether of the bodily organs or of the mind or of the heart. This exertion thus includes organization and planning too. Whatever "wealth" is produced by the combined action of these three factors would be primarily distributed over these three in this manner: one share of it would go to Capital in the form of profit (and not in the form of interest); the second share would go to Land in the form of rent, and the third share would be given to Labor in the form of wages.

Socialism and Islam

As we said, the Islamic system of the distribution of wealth is different from Socialism and Capitalism both. The distinction between the Islamic economy and the Socialist economy is quite clear. Since Socialism does not admit the idea of private property, wealth under the Socialist system is distributed

only in the form of wages. On the contrary, according to the Islamic principles of the distribution of wealth, which we have outlined above, all the things that exist in the universe are in principle the property of Allah Himself. Then, the larger part of these things is that which He has given equally to all men as a common trust. It includes fire, water, earth, air, light, wild grass, hunting, fishing, mines, un-owned and un-cultivated lands etc., which are not the property of any individual, but a common trust. Every human being is the beneficiary of this trust, and is equally entitled to its use.

On the other hand, there are certain things where the right to private property must be recognized if only for the simple reason that without such a recognition it would not be possible to establish the practicable and natural system of economy to which we have alluded while discussing the first object of the distribution of wealth. If the Socialist system is adopted and all capital and all land are totally surrendered to the state, the ultimate result can only be this: we would be liquidating a large number of smaller Capitalists, and putting the huge resources of national wealth at the disposal of a single big Capitalist - the state, which can deal with this reservoir of wealth quite arbitrarily, thus, leads to the worst form of the concentration of wealth. Moreover, it produces another great evil. Since Socialism deprives human labor of its natural right to individual choice and control, compulsion and force becomes indispensable in order to make use of this labor, which has a detrimental effect on its efficiency as well as on its mental health. All this goes to show that the Socialist system injures two out of the three objects of the Islamic theory of the distribution of wealth namely, the establishment of a natural system of economy, and securing for everyone what rightfully belongs to him.

These being the manifold evils inherent in the unnatural system of the Socialist economy, Islam has not chosen to put an end to private property altogether, but has rather recognized the right to private property in those things of the

physical universe which are not held as a common trust. Islam has, thus, given a separate status to Capital and to Land, and has at the same time made use of the natural law of "supply and demand" too in a healthy form. Hence Islam does not distribute wealth merely in the form of wages, as does Socialism, but in the form of profit and rent as well. But, along with it, Islam has also put an interdiction on the category of' 'Interest'', and prescribed a long list of the people who have a secondary right to wealth. It has thus eradicated the great evil of the concentration of wealth, which is an essential characteristic inherent in Capitalism, an evil, which Socialism claims to remedy. This is the fundamental distinction of the Islamic view of the distribution of wealth, which sets it apart from Socialism.

Islam and Capitalism

It is equally essential to understand fully the difference that exists between the Islamic view of the distribution of wealth and the Capitalist point of view. This distinction being rather subtle and complicated, we will have to discuss it in greater detail.

By comparing and contrasting the brief outlines of the Islamic and the Capitalist systems of the distribution of wealth, we arrive at the following differences between the two:-

1. The entrepreneur, as a regular factor, has been excluded from the list of the factors of production, and only three factors have been recognized, instead of four. But this does not imply that the very existence of the entrepreneur has been denied. What it does mean is just that the entrepreneur is not an independent factor, but is included in any one of the three factors.

2. It is not "interest" but "profit" that has been considered as the "reward" for Capital.

3. The factors of production have been defined in a different manner. Capitalism defines' 'Capital'' as "the produced means of production." Hence, Capital is supposed to include machinery etc. as well, beside money and foodstuff. But the definition of "Capital" that we have presented while discussing the Islamic view of the distribution of wealth, includes only those things which cannot be utilized without their being wholly consumed, or, in other words, which cannot be let or leased - for example, money. Machinery is to be excluded from "Capital", according to this definition.

4. In the same way, "land'' has been defined in a more general way. That is to say, all those things have been brought under this head, which do not have to be wholly consumed in order to be used. Hence, machinery too falls under this category.

5. The definition of Labor too has been generalized so as to include mental labor and planning.

Let us now go into the details of this discussion. Under the Capitalist system, the most important characteristic of the entrepreneur (which entitles him to "profit") is supposed to be that he bears the risk of profit and loss in his business. That is to say, from the Capitalist point of view, "profit'' is a kind of reward for his courage to enter into a commercial venture where he alone will have to bear the burden of a possible loss, while the other three factors of production will remain immune from loss, for Capital would get the stipulated interest, Land the stipulated rent and Labor the stipulated wages.

On the other hand, the Islamic point of view insists that the ability to take the risk of a loss should, in reality, inherent with Capital itself, and that no other factor should be made to bear the burden of this risk. Consequently, the Capitalist, in

so far as he takes the risk, is an entrepreneur too, and the man who is an entrepreneur is a Capitalist as well.

Now, there are three ways in which Capital can be invested in a business venture:-

1. **Private business**: The man who invests Capital may himself run the business without the help of any partners or shareholders. In this case the return which he gets may be called "profit" from the legal or popular point of view; but, in economic terms, this "reward" would be made up of (1) "profit", in as much as Capital has been invested, and (2) "wages", as earnings of management.

2. **Partnership**: The second form of investment is that several persons may jointly invest capital, jointly manage the business and jointly bear the risk of profit and loss. In the terminology of the Fiqh, such a venture is called "Shirkat-ul-Aqd" or Partnership in contract.

   According to the terminology of economics, in this case too all the partners will be entitled to "profit" in so far as they have invested capital and also entitled to "wages" in so far as they have taken part in the management of the business. Islam has sanctioned this form of business organization too. This form was quite common before the time of the Holy Prophet ﷺ until he permitted people to retain it, and since then there has been a consensus of opinion on its permissibility.

3. **Co-operation of Capital and Organization (Mudarabah)**: The third form of investment is that one person may invest Capital while another may manage the business, and each may have a share in the profit. In the terminology of Fiqh, it is called "Mudarabah". According to the terminology of economics, in this case, the person

who invests his capital ("Rabb-ul-Mal") will get his share in the form of "profit", while the person who has actually managed the business will get it in the form of "wages". But if the person who has been managing the business ("Mudarib") eventually suffers a loss in the business, his labor will go wasted just as the capital of the investor would go wasted.

This form of business organization too is permissible in Islam. The Holy Prophet ﷺ himself has made such an agreement with Hazrat Khadijah before their marriage. Since then there has been a complete consensus of opinion on this too among the jurists of Islam.

Money Lending Business

The fourth form of investing Capital, which has ever since been practiced in non-Islamic societies is the money-lending business. That is to say, one person lends out capital in the form of a debt, and a second person puts in his labor; if there is a loss it has to be borne by labor, but, profit or loss, interest does accrue to Capital in any case. Islam has interdicted this form of investment.

"O, believers, fear Allah, and give up what is still due to you from the interest (usury), if you are true believers. (2:278)

The Holy Quran also says:

"If you do not do so, then take notice of war from Allah and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it." (2:279)

In these two verses, the phrases "what is still due to you from the interest" and "you shall have the principal" makes it quite explicit that Allah does not condone the least quantity of interest, that "giving up the interest" implies that the creditor should get back only the principal. Thus, one can clearly see

that Islam considers every rate of interest (except zero%) to be totally inadmissible. In the pre-Islamic period, certain Arab tribes used to carry on their trade with the help of money borrowed on the basis of interest from other tribes. Islam puts an end to such transactions altogether. Ibn Juraij says:

"In the pre-Islamic period, the tribe of Banu Amr bin Auf used to take interest from the tribe of Banu-al-Mughira, and the Banu-al-Mughira used to pay this interest. When Islam came, the later owed a considerable amount of money to the former". And further on: ''The Banu-al-Mughira used to pay interest to the Banu Thaqif"

Let it be understood that the position of every Arab tribe was like that of a joint company, carrying on trade with the joint Capital of its individual members. So, when a tribe would borrow collectively from another tribe, it would usually be for the purposes of trade. The Holy Quran prohibited even this practice.

Thus, under the Islamic system of economy, if a man wants to lend his money to a businessman for being invested in business, he will have first to decide clearly whether he wishes to lend this money in order to have a share in the profit, or simply to help the businessman with his money. If he means to earn the right to a share in the profit by lending his money, he will have to adopt the mode of "partnership" or that of "Co-operation'' (Mudarabah). That is to say, he too will have to bear the responsibility of profit or loss - if there is eventually a profit in the enterprise, he shall have a share in the profit; but if there is a loss, he shall have to share the loss too.

On the other hand, if he is lending this money to another person by way of help, then he must necessarily regard this help as no more than help, and must forgo all demand for a "profit". He will be entitled to get back only as much money as he has lent out. Islam considers it not only unjust but also meaningless that he should fix a rate of "interest" and thus place all the burden of a possible loss on the debtor.

This discussion makes it clear that Islam places the responsibility of "taking the risk of loss" on Capital. The man who invests capital in a risk-bearing business enterprise shall have to take this risk.

3

THE OBJECTIVES OF THE DISTRIBUTION OF WEALTH IN ISLAM

If we consider the injunctions of the Holy Quran, it would appear that the system for the distribution of wealth laid down by Islam envisages three objects:

a) ***The establishment of a practicable system of economy: -***
The first object of the distribution of wealth is that it would be the means of establishing in the world a system of economy which is natural and practicable, and which, without using any compulsion or force, allows every individual to function in a normal way according to his ability, his aptitude, his own choice and liking, so that his activities may be more fruitful, healthy and useful. And this cannot be secured without a healthy relationship between the employer and the employee, and without the proper utilization of the natural force of supply and demand. That is why Islam does admit these factors. A comprehensive indication of this principle is to be found in the following verse: -

The condition of "proper utilization" has been assumed because it is possible to make an improper use of forces, and it has been the case under Capitalism. Islam has struck at the very root of such an improper use and has thus eradicated the unbridled exploitation of private property.

''We have distributed their livelihood among them in worldly life, and have raised some above others in the matter of social degrees, so that some of them may utilize the services of others in their work." (43:32)

b) Enabling every one to get what is rightfully due to him:-

The second object of the Islamic system of the distribution of wealth is to enable everyone to get what is rightfully his. But, in Islam, the concept and criteria of this right is somewhat different from what it is in other systems of economy. Under materialistic economic systems, there is only one way of acquiring the right to "wealth", and that is a direct participation in the process of production.

In other words, only those factors that have taken a direct part in producing wealth are supposed to be entitled to a share in "wealth", and no one else. On the contrary, the basic principle of Islam in this respect is that "wealth" is, in principle the property, of Allah Himself and He alone can lay down the rules as to how it is to be used. So according to the Islamic point of view, not only those who have directly participated in the production of wealth but those to whom Allah has made it obligatory upon others to help, are the legitimate sharers in wealth. Hence, the poor, the helpless, the needy, the paupers and the destitutes - they too have a right to wealth. For Allah has made it obligatory on all those producers of wealth among whom wealth is in the first place distributed that they should pass on to them some part of their wealth. And the Holy Quran makes it quite explicit that in doing so they would not be obliging the poor and the needy in any way, but only discharging their obligation, for the poor and the needy are entitled to a share in wealth as a matter of right. Says the Holy Quran:

"In their wealth there is a known right for those who ask for it and those who have need for it." (70:24-25)

In certain verses, this right has been defined as the right of Allah. For example:

"And pay what is rightfully due to Him on the day of harvesting." (6:142)

The word "right" in these two verses makes it clear that participation in the process of production is not the only source of the right to "wealth", and that the needy and the poor have as good a right to "wealth" as its primary owners. Thus Islam proposes to distribute wealth in such a manner that all those who have taken a part in production should receive the reward for their contribution to the production of wealth, and then all those too should receive their share that Allah has given a right to "wealth".

c) *Eradicating the concentration of wealth:*

The third object of the distribution of wealth, which Islam considers to be very important, is that wealth, instead of becoming concentrated in a few hands, should be allowed to circulate in the society as widely as possible, so that the distinction between the rich and the poor should be narrowed down as far as is natural and practicable. The attitude of Islam in this respect is that it has not permitted any individual or group to have a monopoly over the primary sources of wealth, but has given every member of the society an equal right to derive benefit from them. Mines, forests, un-owned barren lands, hunting and fishing, wild grass, rivers, seas, spoils of war etc., all these are primary sources of wealth. With respect to them, every individual is entitled to make use of them according to his abilities and his labor without anyone being allowed to have any kind of monopoly over them.

"*So that this wealth should not become confined only to the rich*

amongst you". (59:7)

Beyond this, wherever human intervention is needed for the production of wealth and a man produces some kind of wealth by deploying his resources and labor, Islam gives due consideration to the resources and labor thus deployed, and recognizes man's right of property in the wealth produced. Every one shall get his share according to the labor and resources invested by him. Says the Holy Quran:

"We have distributed their livelihood among them in worldly life, and have raised some above others in the matter of social degrees, so that some of them may utilize the services of others in their work". (43:32)

But, in spite of this difference among social degrees or ranks certain injunctions have been laid down in order to keep this distinction within such limits as are necessary for the establishment of a practicable system of economy, so that wealth should not become concentrated in a few hands.

Of these three objects of the distribution of wealth, the first distinguishes Islamic economy from Socialism, the third from Capitalism, and the second from both at the same time.

SECTION II

RIBA, ITS PROHIBITION & CLASSIFICATIONS

4

RIBA IN THE QUR'AN

1. **First Revelation *(Surah al-Rum, verse 39)***

   "That which you give as interest to increase the peoples' wealth increases not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold." (30: 39)

2. **Second Revelation *(Surah al-Nisa', verse 161)***

   "And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples' property. We have prepared for those among them who reject faith a grievous punishment (4: 161)"

3. **Third Revelation *(Surah Al 'Imran, verses 130-2)***

   "O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy."

4. **Fourth Revelation *(Surah al-Baqarah, verses 275-81)***

   "Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist, may keep their previous gains, their

case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein for ever." (275)

"God deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner." (276)

"Those who believe, perform good deeds, establish prayer and pay the *zakat*, their reward is with their Lord; neither should they have any fear, nor shall they grieve." (277)

"0, believers, fear Allah, and give up what is still due to you from the interest (usury), if you are true believers." (278)

"If you do not do so, then take notice of war from Allah and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it." (279)

"If the debtor is in difficulty, let him have respite until it is easier, but if you forego out of charity, it is better for you if you realize." (280)

"And fear the Day when you shall be returned to the Lord and every soul shall be paid in full what it has earned and no one shall be wronged. " (281)

5

RIBA IN HADITH

A. General

1. From Jabir رضي الله عنه: The Prophet, ﷺ, may cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike [in guilt]." (Muslim, *Kitab al-Musaqat, Bab la'ni akili al-riba wa mu'kilihi;* also in Tirmidhi and *Musnad* Ahmad)

2. Jabir ibn 'Abdallah رضي الله عنه, giving a report on the Prophet's Farewell Pilgrimage, said: The Prophet, ﷺ, addressed the people and said "All of the *riba* of *Jahiliyyah* is annulled. The first *riba* that I annul is our *riba,* that accruing to 'Abbas ibn 'Abd al-Muttalib [the Prophet's uncle]; it is being cancelled completely." (Muslim, *Kitab al-Hajj, Bab Hajjati al-Nabi,* ﷺ; may also in *Musnad* Ahmad)

3. From 'Abdallah ibn Hanzalah رضي الله عنه: The Prophet, ﷺ, said: "A dirham of *riba* which a man receives knowingly is worse than committing adultery thirty-six times" *(Mishkat al-Masabih, Kitab al-Buyu', Bab al-riba,* on the authority of Ahmad and Daraqutni). Bayhaqi has also reported the above *hadith* in *Shu'ab al-iman* with the addition that "Hell befits him whose flesh has been nourished by the unlawful."

4. From Abu Hurayrah رضي الله عنه: The Prophet, ﷺ, said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest." (Ibn Majah, *Kitab al-Tijarat, Bab al-taghlizi fi al-riba;* also in *Musnad* Ahmad)

5. From Abu Hurayrah رضي الله عنه: The Prophet, ﷺ, said: "*Riba* has seventy segments, the least serious being equivalent to a man committing adultery with his own mother." (Ibn Majah)

6. From Abu Hurayrah رضي الله عنه: The Prophet, ﷺ, said: "There will certainly come a time for mankind when everyone will take *riba* and if he does not do so, its dust will reach him." (Abu Dawud, *Kitab al-Buyu', Bab fi ijtinabi al-shubuhat;* also in Ibn Majah)

7. From Abu Hurayrah رضي الله عنه: The Prophet, ﷺ, said: "God would be justified in not allowing four persons to enter paradise or to taste its blessings: he who drinks habitually, he who takes *riba,* he who usurps an orphan's property without right, and he who is undutiful to his parents." *(Mustadrak al-Hakim, Kitab al-Buyu')*

B. *Riba an Nasiyah*

1. From Usamah ibn Zayd رضي الله عنه: The Prophet, ﷺ, said: "There is no *riba* except in *Nasiyah* [waiting]." (Bukhari, *Kitab al-Buyu', Bab Bay' al-dinari bi al-dinar nasa'an;* also Muslim and *Musnad* Ahmad) "There is no *riba in* hand-to-hand [spot] transactions." (Muslim, *Kitab al-Musaqat, Bah bay'i al-ta'ami mithlan bi mithlin;* also in Nasa'i)

2. From Ibn Mas'ud رضي الله عنه: The Prophet, ﷺ, said: "Even when interest is much, it is bound to end up into paltriness." (Ibn Majah, *Kitab al-Tijarat, Bab al-taghlizi fi al-riba;* also in *Musnad* Ahmad)

3. From Anas ibn Malik رضي الله عنه: The Prophet, ﷺ, said: "When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually." *(Sunan al-Bayhaqi, Kitab al-Buyu', Bab kulli qardin jarra manfa'atan fa huwa riban)*

4. From Anas ibn Malik رضي الله عنه: The Prophet, ﷺ, said: "If a man extends a loan to someone he should not accept a gift." *(Mishkat,* on the authority of Bukhara's *Tarikh* and Ibn Taymiyyah's *al-Muntaqa)*

5. From Abu Burdah ibn Abi Musa رضي الله عنه: I came to Madinah and met 'Abdallah ibn Salam who said, "You live in a country where *riba* is rampant; hence if anyone owes you something and presents you with a load of hay, or a load of barley, or a rope of straw, do not accept it for it is *riba.*" *(Mishkat,* reported on the authority of Bukhari)

6. Fadalah ibn 'Ubayd رضي الله عنه said that "The benefit derived from any loan is one of the different aspects of *riba.*" *(Sunan al-Bayhaqi)* This *hadith is mawquf* implying that it is not necessarily from the Prophet; it could be an explanation provided by Fadalah رضي الله عنه himself, a companion of the Prophet, ﷺ.

C. *Riba al-FadI*

1. From 'Umar ibn al-Khattab رضي الله عنه: The last verse to be

revealed was on *riba* and the Prophet, ﷺ, was taken without explaining it to us; so give up not only *riba* but also *raibah* [whatever raises doubts in the mind about its rightful-ness]. (Ibn Majah,)

2. The Prophet, ﷺ, said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (riba). However, sell gold for silver anyway you please on the condition it is hand-to-hand (spot) and sell barley for date anyway you please on the condition it is hand-to-hand (spot)."

3. From Abu Sa'id al-Khudri رضي الله عنه: The Prophet, ﷺ, said: "Do not sell gold for gold except when it is like for like, and do not increase one over the other; do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away [from among these] for what is ready." (Bukhari, *Kitab al-Buyu', Bab bay'i al-fiddati bi al-fiddah;* also Muslim, Tirmidhi, Nasa'i and *Musnad* Ahmad)

4. From 'Ubada ibn al-Samit رضي الله عنه: The Prophet, ﷺ, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand." (Muslim, *Kitab al-Musaqat, Bab al-sarfi wa bay'i al-dhahabi bi al-waraqi naqdan;* also in Tirmidhi)

5. From Abu Sa'id al-Khudri رضي الله عنه: The Prophet, ﷺ, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like,

and hand-to-hand. Whoever pays more or takes more has indulged in *riba.* The taker and the giver are alike [in guilt]." (Muslim, *ibid;* and *Musnad* Ahmad)

6. From Abu Sa'id and Abu Hurayrah رضي الله عنه: A man employed by the Prophet, ﷺ, in Khaybar brought for him *janibs* [dates of very fine quality]. Upon the Prophet's asking him whether all the dates of Khaybar were such, the man replied that this was not the case and added that "they exchanged a *sa'* [a measure] of this kind for two or three [of the other kind]". The Prophet, ﷺ, replied, "Do not do so. Sell [the lower quality dates] for dirhams and then use the dirhams to buy *janibs.* [When dates are exchanged against dates] they should be equal in weight." (Bukhari, *Kitab al-Buyu', Bab idha arada bay'a tamrin bi tamrin khayrun minhu;* also Muslim and Nasa'i)

7. From Abu Sa'id رضي الله عنه: Bilal رضي الله عنه brought to the Prophet, ﷺ, some *barni* [good quality] dates whereupon the Prophet asked him where these were from. Bilal رضي الله عنه replied, "I had some inferior dates which I exchanged for these - two *sa's* for a *sa'.*" The Prophet ﷺ said, "Oh no, this is exactly *riba.* Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive." (Muslim, *Kitab al-Musaqat, Bab al-ta'ami mithlan bi mithlin;* also *Musnad* Ahmad)

8. From Fadalah ibn 'Ubayd al-Ansari رضي الله عنه: On the day of Khaybar he bought a necklace of gold and pearls for twelve dinars. On separating the two, he found that the gold itself was equal to more than twelve dinars. So he mentioned this to the Prophet, ﷺ, who replied, "It [jewellery] must not be sold until the contents have been valued separately." (Muslim, *Kitab al-Musaqat, Bab bay'i al-qiladah fiha khara-zun wa dhahab;* also in Tirmidhi and Nasa'i)

9. From Abu Umamah رضي الله عنه: The Prophet, ﷺ, said: "Whoever makes a recommendation for his brother and accepts a gift offered by him has entered *riba* through one of its large gates." *(Bulugh al-Maram, Kitab al-Buyu', Bab al-riba,* reported on the authority of Ahmad and Abu Dawud)

10. From Anas ibn Malik رضي الله عنه: The Prophet, ﷺ, said: "Deceiving a *mustarsal* [an unknowing entrant into the market] is *riba.*" (Suyuti, *al-Jami' al-Saghir,* under the word *ghabn;* Kanz al-'Ummal, *Kitab al-Buyu', al-Bab al-thani, al-fasl al-thani,* on the authority of *Sunan al-Bayhaqi)*

11. From 'Abdallah ibn Abi Awfa رضي الله عنه: The Prophet, ﷺ, said: "A najish [one who serves as an agent to bid up the price in an auction] is a cursed taker of *riba.*" (Cited by Ibn Hajar al-'Asqalani in his commentary on al-Bukhari called *Fath al-Bari, Kitab al-Buyu', Bab al-najsh;* also in SuyutT, *al-Jami al-Saghir,* under the word *al-najish* and Kanz al-'Ummal, *op. cit.,* both on the authority of Tabarani’s *al-Kabir)*

6

RIBA AND ITS TYPES

Definition of *Riba or* Interest

The word "*Riba*" means excess, increase or addition, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

This definition of Riba is derived from the Quran and is unanimously accepted by all Islamic scholars. There are two types of Riba, identified to date by these scholars namely 'Riba An Nasiyah' and 'Riba Al Fadl'.

'Riba An Nasiyah' is defined as excess, which results from predetermined interest (sood) which a lender receives over and above the principle (Ras ul Maal)

'Riba Al Fadl' is defined as excess compensation without any consideration resulting from a sale of goods. 'Riba Al Fadl' will be covered in greater detail later.

During the dark ages, only the first form (Riba An Nasiyah) was considered to be Riba. However the Holy Prophet ﷺ also classified the second form (Riba Al Fadl) as Riba.

The meaning of Riba has been clarified in the following verses of Quran:

"O those who believe, fear Allah and give up what still remains of the Riba if you are believers. But if you do not do so, then be warned

of war from Allah and His Messenger. If you repent even now, you have the right of the return of your capital; neither will you do wrong nor will you be wronged." Al Baqarah 2:278-9

These verses clearly indicate that the term Riba means any excess compensation over and above the principal which is without due consideration. However, the Quran has not altogether forbidden all types of excess; as it is present in trade as well, which is permissible. The excess that has been rendered haram in Quran is a special type termed as Riba. In the dark ages, the Arabs used to accept Riba as a type of sale, which unfortunately is also being understood at the present times. Islam has categorically made a clear distinction between the excess in capital resulting from sale and excess resulting from interest. The first type of excess is permissible but the second type is forbidden and rendered Haram.

"Seized in this state they say: 'Buying and selling is but a kind of interest', even though Allah has made buying and selling lawful, and interest unlawful." Al Baqarah 2:275

Classification of Riba

1. The first and primary type is called Riba An Nasiyah or Riba Al Jahiliya.
2. The second type is called Riba Al Fadl, Riba An Naqd or Riba Al Bai.

Since the first type was specified in the Quranic verses before the sayings of the Holy Prophet ﷺ, this type was termed as Riba al Quran. However the second type was not understood by the Quranic verses alone but also had to be explained by the Holy Prophet ﷺ, it is also called Riba al Hadees.

Riba An Nasiyah

This is the real and primary form of Riba. Since the verses of Quran has directly rendered this type of Riba as haram, it is called Riba Al Quran. Similarly since only this type was considered Riba in the dark ages, it has earned the name of

Riba Al Jahiliya. Imam Abu Bakr Hassas Razi has outlined a complete and prohibiting legal definition of Riba An Nasiyah in the following words:

"That kind of loan where specified repayment period and an amount in excess of capital is predetermined."

One of the ahadith quoted by Ali ibn at Talib (RAA) has defined Riba An Nasiyah in similar words. The Holy Prophet ﷺ said:

"Every loan that draws interest is Riba."

The famous Sahabi Fazala Bin Obaid has also defined Riba in similar words:

"Every loan that draws profit is one of the forms of Riba"

The famous Arab scholar Abu Ishaq az Zajjaj also defines Riba in the following words:

"Every loan that draws more than its actual amount"

Riba An Nasiyah refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. The prohibition of Riba An Nasiyah is one of those issues which have been confirmed in the revealed laws of all Prophets (AS). Some of the old testaments has rendered Riba as haram (See Exodus 22:25, Leviticus 25:35-36, Deutronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12). The Quran has also stated the prohibition of Riba in various verses, has warned those who persist in practicing it of a war which is certain to be declared on them by Allah Himself and His messenger and has seriously threatened those engaged as writer, witness and dealer in Riba transactions. These verses and ahadith will be discussed

at length in a separate chapter called "The prohibition of Riba in the light of Quran and hadith".

According to the above definition of Riba An Nasiyah, the giving and taking of any excess amount in exchange of a loan at an agreed rate is included in interest irrespective whether at a high or low rate. It has been proven through ahadith that the Holy Prophet ﷺ paid excess at the loan repayment time but since this excess was not paid through an agreed rate, it cannot be called interest. This clarifies that the word "draws" in the hadith definition" *The loan that draws interest is Riba."* has been used to highlight the giving and taking of excess amount through an agreed rate in the loan contract. Due to this, Imam Abu Bakr Hasas has added the word "condition" to the definition.

The fact that Riba An Nasiyah is categorically haram has never been disputed in the Muslim community.

In short, the Riba of today which is supposed to be the pivot of human economy and features in discussions on the problem of interest is nothing but this Riba, the unlawfulness of which stands proved on the authority of the seven verses of the Quran, of more than forty ahadith and of the consensus of the Muslim community.

Wisdom behind the prohibition of Riba An Nasiyah

First of all, we should realize that there is nothing in the entire creation of the world, which has no goodness or utility at all. But it is commonly recognized in every religion and community that things which have more benefits and less harms are called beneficial and useful. Conversely, things that cause more harm and less benefit are taken to be harmful and useless. Even the noble Quran, while declaring liquor and gambling to be haram, proclaimed that they do hold some benefits for people but the curse of sins they generate is far greater than the benefits they yield. Therefore, these cannot be called good or useful; on the contrary, taking these

to be acutely harmful and destructive, it is necessary that they be avoided.

The case of Riba An Nasiyah is not different. Here the consumer of Riba does have some casual and transitory profits apparently coming to him, but its curse in this world and in the Hereafter is much too severe as compared to this benefit. The Riba consumer suffers such a spiritual and moral loss that it virtually takes away the great quality of being 'human' from him. An intelligent person who compares things in terms of their profit and loss, harm and benefit can hardly include things of casual benefit with an everlasting loss in the list of useful things. Similarly no sane and just person will say that personal and individual gain which causes loss to the whole community or group is useful. In theft and robbery for example, the gain of the gangster and the take of the thief is all too obvious but it is certainly harmful for the entire community since it ruins its peace and sense of security.

Riba Al Fadl

The second classification of Riba is Riba Al Fadl. Since the prohibition of this Riba has been established on Sunnah, it is also called Riba Al Hadees.

Riba Al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase & sale as explained in the famous hadith:

The Prophet ﷺ said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (Riba). However, sell gold for silver anyway you please on the condition it is hand-to-

hand (spot) and sell barley for date anyway you please on the condition it is hand-to-hand (spot)."

This hadith enumerates 6 different commodities namely:

1) Gold
2) Silver
3) Dates
4) Wheat
5) Salt
6) Barley

These six commodities can only be bought and sold in equal quantities and on spot. An unequal sale or a deferred sale of these commodities will constitute Riba. These six commodities in fiqh terminology are called "Amwal-e-Ribawiya". Does this hadith apply only to the items mentioned in it? Does it concern sales of barley or wheat but not rice? Of dates but not raisins? A complete legal definition differs in every fiqh. Scholars such as Taoos and Qatada hold that Riba Al Fadl includes these specified types only, however a majority of Islamic scholars believe that some other commodities should also be included. In order to answer the question, which other commodities should be included, some fiqhs hold that the characteristics which are common amongst these items can be used as basis (*illat)* for Riba Al Fadl. An *illat* is the attribute of an event that entails a particular divine ruling in all cases possessing that attribute; it is the basis for applying analogy. *Ribawi* goods are therefore goods that exhibit one of the efficient causes occasioning application of Riba rules. Various schools define these causes differently:

Imam Abu Hanifa

Imam Abu Hanifa sees only two common characteristics namely:

1) Weight
2) Volume

Meaning all these six goods are sold by either weight or volume. Therefore all those commodities, which have weight or volume and are being exchanged, with the same commodity will fall under the rules of Riba Al Fadl.

Imam Shafi

The two characteristics observed by Imam Shafi are:

1) Medium of Exchange or
2) Eatable

Therefore this law will apply on everything edible or having the natural ability of becoming a medium of exchange (currency).

Imam Maalik

Imam Maalik identified the following two characteristics:

1) Eatables and
2) Preservable

Imam Ahmad Bin Hanbal

Three citations have been related to him:

i) First citation conforms to the opinion of Imam Abu Hanifa.
ii) Second citation conforms to the opinion of Imam Shafai.
iii) Third citation includes three characteristics at the same time namely edible, weight and volume.

After a detailed study of the above schools of thought, it has been declared by Islamic scholars that if a commodity bears both of the two characteristics namely; it has weight and can be used as a medium of exchange, then the following two kinds of transactions are not allowed when the same goods are being exchanged:

- A deferred sale of goods (A deferred sale is when the goods are returned/or paid for after some undetermined period)

- A sale of unequal quantities of the same goods

However, when only one of the two characteristics is present to term the sale as Riba Al Fadl, then exchange of unequal goods are allowed but deferred sale is not allowed.

Wisdom behind the prohibition of Riba Al Fadl

The prohibition of Riba Al Fadl is intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back-doors to Riba An Nasiyah because in the Islamic Shariah, anything that serves as a means to the unlawful is also unlawful.

The laws of Riba Al Fadl

After closely analyzing the meaning and interpretation of the above ahadith and their explanation in further ahadith along with issues raised in reference work of Hanafi fiqh, the following rules and laws governing Riba Al Fadl are derived:

1. It is evident that the exchange of homogeneous commodities will only be required if they differ in quality and characteristic e.g. different genus of rice and wheat, superior quality gold and inferior quality gold, mineral salt and sea salt etc. The exchange of any of these six commodities with itself, but differing in types/quality (which is called barter in modern terminology), even when considering market rate, is prohibited in unequal

amount. The reason being that by exchanging these commodities in unequal amounts there is a fear of developing the rationale in a person eventually leading to interest (sood) based earnings and illegal benefits. Such transactions might also lead to defrauding. For example, a shrewd trader may claim that a kilogram of a specific brand of wheat is equivalent to 3 kilograms of the other kind because of the excellence of its quality, or this unique piece of gold ornament is equivalent in value to twice its weight in gold; in such transactions there undoubtedly is defrauding of people and harm to them.

As a step to prevent this state, the Shariah has made it a law that exchange of any of these six commodities with itself but differing in quality, is allowed in only one of the following forms:

a) Any difference in value/quality should be ignored and the commodities should be exchanged in equal amounts (equal weight and volume).

b) Instead of direct exchange of commodities of the same kind, a person should sell his commodity against cash at the market value and buy someone else's commodity in exchange of cash proceeds at the market value.

2. One of the ways of transacting commodities of the same kind is that a person has a raw material and someone else has a product made of that material and both decide to exchange their product. In this case, one has to see whether:

   a) ***The characteristics of this product has been totally changed by the industry:*** For eg. the remarkable changes that transform raw cotton into cloth or iron into machinery. In this case, it is permissible to transact lesser amount of cloth against greater amount

of raw cotton or raw iron having more weight against machinery having lighter weight.

b) ***Little difference has been made to its original form after its formulation:*** For eg. gold which changes its shape in the form of jewelry. In this case, the Shariah'h holds that such a transaction should not happen in the first place or if it does, the exchange should be in equal weights in order to discourage unfair deals. Another alternative would be to sell gold against cash and the cash proceeds are used to buy the needed jewelry. This is because it is not possible in a barter transaction, except for an expert, to visualize the fair equivalent of one commodity in terms of all other goods. Hence, the equivalent may be established only approximately thus leading to some injustice to one or the other party. The use of money could therefore help reduce the possibility of an unfair exchange.

3. Different commodities can be unequally exchanged but deferred payment is not allowed. For eg. one kg wheat can be sold against 2 kg date or one gram of gold can be exchanged against 4 grams of silver on the condition that they are spot transactions reason being that such a transaction will surely be carried on the market rate. For eg. a person who wants to exchange silver for gold on spot will only transact as per the market rate. However, if the transaction is on credit, there is a possibility, no matter how minor, of stepping into interest that cannot be ignored. For eg. a buyer who has traded 80 tolas silver on credit today on the understanding that it will be exchanged against 2 tolas gold after a month has in fact no means to find in advance that 40 tolas silver will be equivalent to one tola gold after a month. Therefore this ascertaining of value in advance actually signifies its roots in interest and gambling. Similarly the seller who has accepted credit has in fact yielded to gambling by hoping that the ratio of gold and silver might come down from

1:40 to 1:35. The law of exchanging different commodities only at spot has been established due to this reason.

The general conditions of sale, however, should be borne in mind while making a trade transaction so that the goods are specified in addition to the cash aspect of the transaction. The correct way of specifying is that gold and silver should be under the possession of the sellers or delivered at the place of contract because both goods have the original (natural) price, which cannot be specified until they are delivered.

This rule applies to only exchange of gold and silver. Other goods can be exchanged against each other without delivery and can be specified any other way but will be restricted to cash transaction.

For eg. Zaid made a spot sale of one kg wheat to Bakar with 2 kg salt against future delivery after having identified their goods, this transaction is allowed in Shariah since it meets both conditions:

- The transaction is on spot.
- It is also specified.

However, if Zaid was selling one tola gold to Bakar against 40 tola silver, then it is necessary that both take delivery of their purchased goods at the place of contract because without delivery, goods cannot be specified.

To sum up, the Hanafi jurists maintain that in case of commodities that weigh or measure, it is illegal to transact unequally or on credit. But in case of different commodities unequal exchange is legal but credit remains illegal; the transaction in this case too should be spot.

7

COMMERCIAL INTEREST AND USURY

In the 17th century, two new technical terms of interest emerged after the establishment of banking system, namely:

1. ***Tijarti Sood*** (Commercial Interest): Interest paid on loan taken for productive & profitable purposes.

2. ***Sarfi Sood*** (Usury): Interest paid on loan taken for personal need and expenses.

THE BACKGROUND OF BOTH TYPES:

The present day banking system, which has given interest the moral and legal license, is the backbone of the prevalent capitalism.

When Muslim countries became subjugated to west in their economic field, some westernized Muslims in the 19th century, on one side, saw the increasing progress of the west in trade and industry and on the other side saw the shattering economic condition of fellow Muslims states. They also became conscious of the fact that banking is inevitable in the field of trade and industry not only on national level but also internationally. This prompted them to say that only usury is *haram* (illegal) but not commercial interest because rendering commercial interest *haram* would pose irresolvable problems to their way up to industrialization and economic progress. They only included usury in the term "Riba" as categorically prohibited in Qura'n and sunnah and freed commercial

interest from it calling it totally different from the western concept of interest. Therefore, it was concluded that the prohibition of Riba was restricted to usury while commercial interest was perfectly Islamic.

There are two schools of thought on this issue. A detailed analysis of their arguments is discussed as under:

1. ***First School:***
   This school presents two arguments to support their point that only usury (not commercial interest) is prohibited in Islam:

Argument 1

"Riba as practiced during the days of the Prophet ﷺ was only Usury"

Counter argument

This claim is groundless, since Islam when prohibiting something does not only prohibit one form of it that is prevalent, but all forms that might erupt in future. The changed state does not change the ruling for eg. Qura'n has prohibited the following:

a) ***Liquor (Khamar)***: During the time of Prophet ﷺ its form and the way of production was totally different from that of the present day liquor but the ruling remains unchanged even though the form has changed.

b) ***Pork (Khinzeer)***: Irrespective how clean the present day breeding of pigs in high class farms may be, pork will stay prohibited and cannot be rendered *halal* (legal).

c) ***Corruption/Immorality (Al Fahsha)***: Although a lot of sophisticated ways have been developed of this evil from the time of Qura'nic revelations prohibiting it, the ruling stands forever.

The same applies to interest and gambling. By claiming that it was in a different form during Prophet's ﷺ time does not change its ruling. It remains unchanged just as in case of *Khamar, Khinzeer* and *Al Fahsha*.

Argument 2
"Commercial interest did not exist in the days of Prophet ﷺ"

Counter argument
This claim is also wrong. If one glances through the Islamic and pre Islamic history of Arabia, it will be evident that the interest type at that time was not restricted to usury but loans were granted for commercial and profitable purposes. To quote some examples:

a) "The tribe of Umro bin Aamir used to take interest from the tribe of Mughairah. At the advent of Islam, Mughairah owed heavy interest to Umro bin Aamir." In this narration, the transaction of interest between 2 tribes of Arabia have been pointed out who actually operated as trading companies; both tribes were very wealthy. Could it be that 2 wealthy tribes transacted interest just for personal need and expenses? The interest was simply commercial!

b) History of the city of Ta'if tells us that it was only second to Makkah in trade (their main exports being liquor, raisins, currants, wheat, wood etc) and industry (major being leather and dyeing). The tribe of '*Saqeef*' (Jewish tribe) advanced cash on interest, not only to the natives of Ta'if, but the business community of Makkah as well eg. the tribe of Mughairah who were their permanent customer. This advancement, which was not only restricted to cash but also to commodities between wealthy tribes of Taif and Makkah who were usually traders and businessmen, was only for their commercial purposes

and not for their consumption and personal needs. One of the ways of receiving interest was to double the principle amount plus interest in case of non payment of loan and this practice was applied to both cash as well as commodities. They had become accustomed to it.

At the time of signing the peace treaty with the people of Ta'if, the Prophet ﷺ imposed conditions: i) Total elimination of interest based transactions. ii) Giving up of interest owed to and from them.

c) The practice of making 2 trade trips, one to Yemen in winters and the other to Syria in summer was started by the tribe of Quraish of Makkah. These trips proved to be very profitable especially since being custodians of Kaa'ba, Quraish were looked at with respect, granted special concessions and protected in transit which was a necessity at that time. This way business & trade became their only means of livelihood. Investment became the order of the day in which women also took part and its circulation flourished and multiplied. With this background in mind, one can easily visualize that the city of Makkah more or less became the clearing house or the banking city and accustomed to their related amenities. It was only natural that interest was one of them. Since they advanced cash for commercial purposes and charged compound interest incase of default by the traders, and this earning of interest was their trade, they argued when Qura'n rendered interest *haram (illegal)* that the transaction of interest based loans is a type of trade in which the return on capital can be earned as in the case of rent received from assets. They could not differentiate between excess in shape of profit during a trade and excess in the shape of interest at the time of repayment of loan.

d) Therefore in pre Islamic days, we see that Syedna Abbas bin Abdul Muttalib and Syedna Khalid bin Waleed formed a company with joint capital whose prime business was cash advancement on interest. Similarly Syedna Usman was one of the wealthy businessmen who lent money on interest. There were many other traders dealing full time in interest extending a network of interest based transactions.

e) The way Syedna Zubair bin Awwam, who was famous for his trustworthiness, operated was quite similar to that of modern banking system. People used to deposit with him their capital as Amanah (trust or security). However, Syedna Zubair used to make it clear to the depositors that he would accept the deposits as a 'loan' and not as 'security' (Amanah). Because he knew that he will not be fully liable according to Shariah in case these Amanahs got destroyed but in case of having them as a loan, he will be fully liable to pay them back. He was afraid that in case of losing any deposited amount, his image as the trustworthy caretaker would be damaged. He therefore used the term 'loan' for such deposits to ensure guaranteed payment so that he enjoys everyone's confidence in him. Another reason for using the word 'loan' was to legalize trading and earning profits on such deposits. Because if he got those deposits as Amanah, he could not utilize it for his business, as it is not permissible in Shariah to use Amanah. This clearly shows that borrowing in those days was not only for consumption purposes but for commercial purposes as well. Syedna Zubair left a will with his son Syedna Abdullah bin Zubair before he died to sell his property to repay the loan, if required. The total amount calculated after his death for repayment by his son was 22 lacs. It is obvious that a rich Sahaba such as Syedna Zubair did not owe this loan of 22 lacs out of any need; rather it was an

investment of securities that was circulating in trade.

ANOTHER CLEAR ARGUMENT

Syedna Abu Hurairah narrated that the Prophet ﷺ said, "He who does not abandon *Mokhabara,* will be caught in a war against Allah & His Prophet."

In this narration Prophet ﷺ has rendered *Mokhabara* illegal just like riba and has declared a war against those who indulge in it just like riba.

What is *Mokhabara*?

Its actually a division of the crop by agreement between the landlord and cultivator in which the landlord gives his land to cultivator for cultivation purposes in order to get his pre-agreed amounts of the crop irrespective whether the production is low or high. For eg. "A" lends his land to 'B' for cultivation on the condition that he will get a predetermined portion on each crop eg. 5 mounds. Such a transaction is called *Mokhabara.*

Prophet ﷺ had called *Mokhabara* a form of riba. Now one should think over whether he referred to usury as the form of riba or he referred to commercial interest. It is similar to commercial interest as both Mokhabara and commercial interest are used for productive businesses. Whereas in the case of usury, the borrower uses the loan for personal use and not productive purposes.

To sum up, Prophet ﷺ included Mokhabara in *riba* that has no similarity with usury, rather with commercial interest. The fact that during Prophet's ﷺ time, the dealing in commercial interest was common is proven and also that this form is prohibited.

2. ***Second School***:
   This group present two arguments justifying their point of view that are mentioned below:

Argument 1
The factor leading to prohibition of Riba (Interest) is that if a borrower faces a loss, he still has to pay an excess amount over the principal, which is basically an exploitation of his need whereas the lender on the other hand gets an increase on his surplus capital without any effort which is unjust. But this factor is not found in commercial interest since both the borrower as well as the lender gets profit; the borrower on the amount he has circulated in business and the lender in shape of interest over his principle amount. Therefore, no one faces unfairness or injustice in this transaction.

Counter argument
This argument is quite appealing and attractive at the face value, as it is based on the assumption that no one suffers in case of commercial interest. But after analysis, it is proven that Quran has not only prohibited that one party faces a loss and the other gets profit but has also prohibited one party getting confirmed profit and the other party unconfirmed profit from the same investment as we have studied above in the case of *Mokhabara.*

Argument 2
This argument is based on the Qura'nic verse "*O believers do not devour one another's possession wrongfully; rather than that, let there be trading by mutual consent*" (*Al Nisa* verse 29). In the above verse, Qura'n has prohibited "*Wrongful devouring*" which will only arise if the consent of one of the parties is absent and naturally the party who is devouring consents, the other party never consents; he only gives in since he has no other option. So we come to the conclusion that if the consent and satisfaction of both parties is present in a deal, it cannot be called "Wrongful devouring". According to this logic, commercial interest is permissible since the mutual consent is present of both parties whereas riba is prohibited only when one party is getting the excess out of his selfishness and the other party is encountering the loss, as he has no other alternative.

Counter argument:
This argument is of superficial nature. Mutual consent is not the criteria to render anything prohibited or not in Islam. Would the act of adultery be allowed if the condition of mutual consent is fulfilled? Similarly, there are many transactions in business, which are rendered illegal even with mutual consent. For reference see "Abwab ul Buyu al Batila" where *Muhaqila* and *Talqi al Jalab* being forms of *Bai* where the mutual consent and satisfaction is present and is prohibited by Prophet ﷺ. Similarly, mutual consent is present in commercial interest and gambling too but in spite of that, it has been prohibited. Therefore no such criteria exist in the legality of any transaction that both parties approve; rather the approval should be on the transaction, which has not been prohibited by *Shariah*. To quote the words of Qura'n "*Except the legitimate business…….*"

8

SIMPLE AND COMPOUND INTEREST

Riba an Nasiyah can be classified into two types:

- Simple Interest (Sood-e-Mufrid)
- Compound Interest (Sood-e-Murakkab)

Definition of Simple Interest:
Interest calculated only on the initial investment.

Definition of Compound Interest:
Reinvestment of each interest payment on money invested, to earn more interest.

During the pre-Islamic era, when a borrower used to fail to pay back the principal and interest charged on him, then the lender used to extend the loan on the condition that the interest will also become part of the loan (essentially Compound Interest). The following verses of Quran were revealed in order to stop the people from such practices:

"O believers, take not doubled and redoubled interest, and fear God so that you may prosper." (Surah Al 'Imran, verses 130-1)

To eradicate this abominable practice of the period of ignorance, this verse was revealed. By mentioning the practice of doubling and redoubling, it was condemned and declared unlawful in view of its adverse impact on the community and the selfishness that it bred. It does not mean that if there is no doubling and redoubling (i.e., if there is

simple interest, in today's jargon), then it is lawful. No. In Surah Al Baqarah (The Cow) and Surah An Nisa (The Women), the prohibition of interest in its entirety and in absolute terms is clearly mentioned, whether or not there is doubling and redoubling.

Since the aforementioned verse prohibits the compound interest only, some people misinterpret it even today that compound interest alone is forbidden in Islam, not the simple interest. They fail to see that there is absolute prohibition of simple interest in a number of other Quranic verses. The reason that the above verse specifically uses the words "*doubled and redoubled interest* " is to highlight the shameful aspect of compound interest and not to limit the scope of riba only to compound interest. This is similar to Allah's command "Do not bargain on my orders for paltry gains in this world." The reason for mentioning paltry gains is that even if all conceivable material goods and luxuries of this world are obtained in exchange for ignoring Allah's commands, even then this is a paltry gain. It does not obviously mean that it is prohibited to obtain paltry gains but permissible to obtain (by one's standard or judgment) a hefty price. Similarly, in the Ayat under consideration, the mention of doubling and redoubling is to condemn the shameful practice rather than limit its permissibility.

Verses on absolute prohibition of Simple and Compound Interest

"O believers, fear God and give up the interest that remains outstanding (i.e. whether it is simple interest or multiplied interest) if you are believers."
(Surah Al-Baqarah, verse 278)

"If you do not do so, then be sure of being at war with God and His Messenger. But, if you repent, you can have your principal (only - not any kind of interest or premium). Neither should you commit injustice nor should you be subjected to it.

(Surah al Baqarah, verse 279)

The above two verses demand to abandon the amount of riba and directs that only the principal amount should be paid back, nothing in excess. The second verse explains that any excess on principal, no matter how insignificant, is cruel.

The following hadith also proves that both simple and compound interest are forbidden:

"Listen! all Riba liable to you in the pre-Islamic days have been completely eliminated. You have to pay back the principal amount only. Neither hurt someone nor get hurt by someone. And the first riba to be completely eliminated is Abbas bin Mutalib's.

The above evidence proves that the claim that 'only compound interest is prohibited and any riba less than that is allowed in Islam,' is wrong. Any amount in excess of the principal fixed in the contract of a loan is called Riba An Nasiyah. If simple interest is accepted, it can also be used to give out additional loans, which will again pay out simple interest. In effect, the interest will keep on becoming part of the principal, which is essentially compound interest.

SECTION III

ISLAMIC CONTRACT

9

ISLAMIC CONTRACT

In Islamic jurisprudence what is the ruling of putting a condition on a contract or agreement?

There are four basic rules for judging the validity of conditions in a contract:

1) A condition, which is not against the contract, is a valid condition.
2) A condition, which seems to be against the contract, but it is in the market practice, that type of condition is not void, if its voidness is not proven with the clear injunctions of the Holy Quran and Sunnah. For example 'A' buys an air conditioner on a condition that the seller will provide him five-year guarantee and one year free service. This type of condition does not invalidate the contract.
3) A condition that is against the contract and not in the practice of market but it is in favor of one of the contractors or subject matter, this type of condition is void. For example if 'A' says he sells a car with a condition that he will use it on a fixed date every month, this contract will be void.
4) A condition, which is against the contract, not in the market practices and not in favor of any contractor, is not a void condition.

Now a question arises what is the ruling of void condition, whether it invalidates the contract or not?

The answer is that there is a detail about the impacts of void condition. Sometimes a void condition invalidates the contract and sometimes it does not invalidate the contract, however, the condition itself is annulled.

To elaborate this, Islamic jurists and scholars have written that the compensation (*Uqood Muawadha*) like sale, purchase, lease agreements become void by putting void condition. However, non-compensatory (voluntarily) agreements (*Uqood Ghair Muawadha*) like contract of loan (*Qard-e-Hasanah*), do not become void because of void condition. The void condition, however, becomes itself ineffective. For example if 'A' gives to 'B' a loan with a condition of premium at the time of repayment, this condition of interest is void. However, this condition does not invalidate the contract, therefore all transaction done by this borrowed money, will be valid. But the condition of interest itself is revoked; therefore 'B' is not liable for the payment of interest.

Rights, Responsibility and Obligation in a contract:
In Islamic Fiqh, some contracts are such that rights and obligations are also attached to the Agent doing the contract on behalf of the Contracting Party eg. Sales Contract, Ijara, Istisna, Salam etc. While in others Principal has all the responsibilities, rights & obligations eg. Nikah.

10

SALE

Sale (Bai) is commonly defined in shari'ah as "the exchange of a thing of value by another thing of value with mutual consent". More specifically it means "the sale of a commodity in exchange of cash"

1. **Valid Sale (*Bai Sahih*):**
   A sale becomes valid if the following elements are present as well as the conditions in the attached chart # 2 are complied with:
   - Contract *(Aqd)*
   - Subject Matter *(Mabe'e)*
   - Price *(Thaman)*
   - Possession or delivery *(Qabza)*

2. **Void/Non Existing Sale (*Bai Baatil*):**
   Sale will be void if any one of the conditions of offer and acceptance (1.1), conditions of Buyer & Seller (1.2) and sold good conditions (2.1 – 2.5) are not complied with. In a void sale, the buyer does not have title to subject matter and seller does not have title to price. Both subject matter and price cannot be used lawfully. The produce of both shall be unlawful.

3. **Existing sale but void due to defect *(Bai Fasid*)**
   Sale will exist but will be void due to defect if the conditions of contract (1.3), sold good conditions (2.6 & 2.7) and conditions of price (3.1 & 3.2) are not complied with. However, if the defect is rectified the sale becomes

valid. In a *fasid* sale, the buyer should not possess the subject matter. If possessed with the consent of the seller, title or ownership will pass to the buyer but usage of subject matter will be impermissible. He must return it to the seller.

4. **Valid but disliked sale (*Bai Makrooh*):**
   A sale will be *Makrooh* when the transaction is complete and one gets possession of the goods but is disliked eg. sale after *Juma Azaan*, sale after hoarding or where a third party intervenes to buy something which was under negotiation of sale between other parties.

Types of Sales

Following are the common types of sales

1. **Bai Musawamah:** It refers to normal sale in which cost price is not known.
2. **Bai Murabaha:** It refers to a sale in which cost and sale price is known to the buyer.
3. **Bai Muqayada:** It refers to barter sale excluding currency sale.
4. **Bai Surf:** It refers to the sale of gold, silver and currency.
5. **Bai Salam:** It is a kind of sale in which payment is spot while the delivery of the good is deferred.
6. **Bai Istisna:** It refers to such sale in which commodity is transacted before it comes into existence. It is basically an order to manufacture.
7. **Bai Muajjal:** It refers to such sale in which payment is delivery is spot while payment is deferred but cost is not known.

11

VALID SALE

A valid sale has 4 big elements:

1. **Contract or transaction (*Aqd*)**

1.1 Offer & acceptance (*Ijab-o-Qobool*): The term "Offer" means that one person proposes to either sell his commodity to another person or buy from him and "Acceptance" means that the person who has been offered gives his approval of the proposal. Offer and acceptance are always done in past tense eg. "I have sold" or "I have purchased" etc. There are two ways of doing it:

1.1.1 Oral (*Quali*): By saying.

1.1.2 Implied (*Isharaa*): By indicating. This is of two types:

1.1.2(a) Credit Sale (*Istijrar*): Eg. settlement of the bill at the end of the month.

1.1.2(b) Hand-to-Hand Sale (*Taati*): Exchange of money with goods without uttering *Ijab-o-Qobool* for procedure adopted in contemporary stores.

1.2 Buyer & seller (*Muta'aquadeen*): Both must be :

1.2.1 Sane : Should be mentally sound at the time of contract.

1.2.2 Mature: Should be adult, however, if minor, must understand the nature of transaction.

1.3 Conditions of contract (*Sharaet-e-Aqd):*

1.3.1 Sale must be non-contingent

The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance. Eg. 'A' sells his car stolen by some anonymous person to 'B' who purchases it in the hope that he will manage to recover it. The sale is void.

1.3.1(a) Unconditional contract: The sale must be unconditional for eg. 'A' buys a car from 'B' with a condition that B will employ his son in his firm. The sale is conditional and hence invalid.

1.3.1(b)Under reasonable conditions: The conditions which do not go against the contract for eg.'A' tells 'B' to deliver the goods within a month, the sale is valid.

1.3.1(c)Under unreasonable condition but in market practice: If a sale is under unreasonable condition but is in market practice, the sale is valid. For eg. 'A' buys a refrigerator from 'B' with a condition that 'B' undertakes its free service for 2 years. The condition being recognized as a part of the transaction, is valid and the sale is lawful

1.3.2 Sale must be immediate

The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. If the parties wish to effect a valid sale, they will have to effect it afresh when the future date comes or the contingency actually occurs. Eg. 'A' says to 'B' on the first of January: "I sell

my car to you on the first of February". The sale is void, because it is attributed to a future date." Similarly, if 'A' says to 'B': "If x party wins the elections, my car stands sold to you", the sale is void because it is contingent on a future event.

2. **Sold good or subject matter (*Mube'e*)**

2.1 *Existable*

The subject matter of sale must exist at the time of sale. Thus, a thing which has not yet come into existence cannot be sold. If a non-existent thing has been sold, even with mutual consent, the sale is void according to shari'ah. Eg. 'A' sells the unborn calf of his cow to 'B'. The sale is void.

2.2 Valuable

The subject of sale must be a property of value. Thus a thing having no value according to the usage of trade eg. a leaf or a stone on a roadside cannot be sold or purchased.

2.3 Usable

The subject of sale should not be a thing which is not used except for a *haram* purpose, like pork, alcohol etc.

2.4 Capable of ownership/title

The subject matter should not be anything, which is not capable of ownership/title for eg. sea or sky.

2.5 Capable of delivery/possession

For eg. an unconstructed building, cannot be possessed since it is non-existent.

2.6 Specific & quantified

The subject of sale must be specifically known and identified either by pointing or by detailed specification that can distinguish it from other things, which are not sold. Eg. There is a building comprising of a number of apartments built in the same pattern. 'A' – the owner of the building says to 'B', "I sell one of these apartments to you"; 'B' accepts.

The sale is void unless the apartment intended to be sold is specifically identified or pointed out to the buyer.

2.7 Seller must have title & risk

The subject matter of sale must be in the ownership of the seller at the time of sale. Thus what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership and risk, the sale is void. Eg. 'A' sells to 'B' a car which is presently owned by 'C' but 'A' is hopeful that he will buy it from 'C' and shall deliver it to 'B' subsequently. The sale is void, because the car was not owned by 'A' at the time of sale. The speculation in shares is another example.

3. **Price *(Thaman)***

3.1. Quantified (Maloom)

The measuring unit of the price should be known eg. currency etc.

3.2 Specified & certain (Muta'aiyan)

For a sale to be valid, the price should be ascertained and specified eg. the total amount etc. If the price is uncertain, the sale is void. Eg. 'A' says to 'B': "If you pay within a month, the price is Rs.50 but if you pay after two months, the price is Rs.55". 'B' agrees. The price in this case is uncertain and therefore the sale is void unless anyone of the two alternatives is agreed upon by the parties at the time of sale.

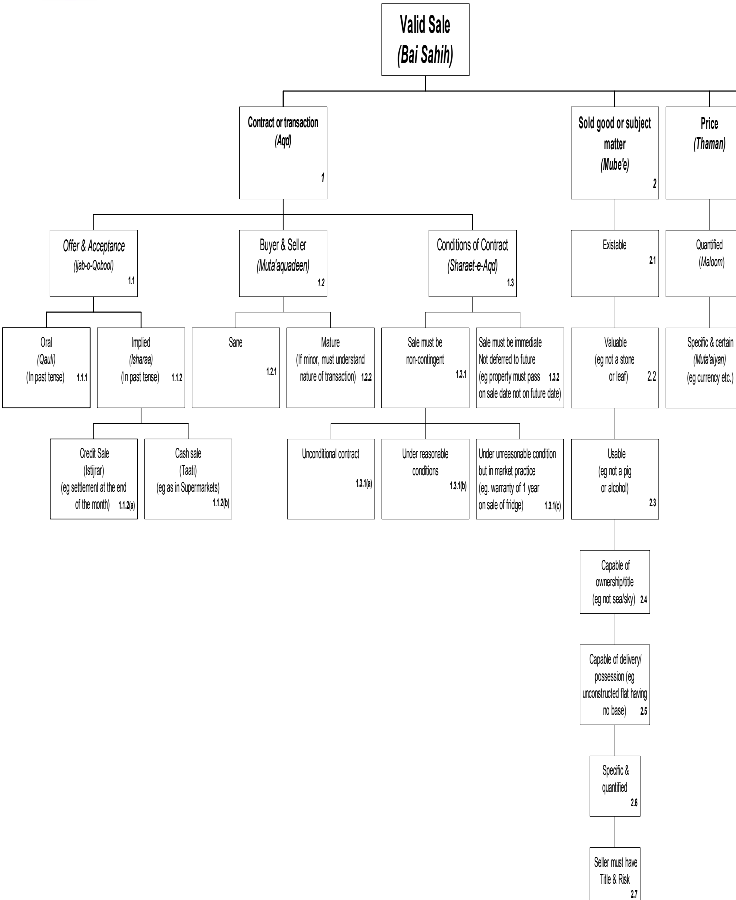
4. **Delivery or possession (*Qabza*)**

The subject of sale must be in the physical or constructive possession of the seller when he sells it to another person. This is done only in respect of movable goods, not immovable.

4.1 Physical (Haqiqi): For eg. 'A' has purchased a car from 'B'. 'B' has not yet delivered it to 'A' or to his agent.

However, 'A' cannot sell the car to 'C'. If he sells it before taking its delivery from 'B', the sale is void.

Constructive (Hukmi): "Constructive possession" means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his control and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction. For eg. 'A' has purchased a car from 'B'. 'B' after identifying the car has placed it in a garage to which 'A' has free access and 'B' has allowed him to take the delivery from that place whenever he wishes. Thus the risk of the car has passed on to 'A'. The car is in the constructive possession of 'A'. If 'A' sells the car to 'C' without acquiring physical possession, the sale is valid.


Valid Sale
(Bai Sahih)
Contract or transaction
(Aqd)
1
Sold good or subject matter
(Mube'e)
2
Price
(Thaman)
Offer & Acceptance
(Ijab-o-Qobool)
1.1
Buyer & Seller
(Muta'aquadeen)
1.2
Conditions of Contract
(Sharaet-e-Aqd)
1.3
Existable
2.1
Quantified
(Maloom)
Oral
(Qauli)
(In past tense) 1.1.1
Implied
(Isharaa)
(In past tense) 1.1.2
Sane
1.2.1
Mature
(If minor, must understand nature of transaction) 1.2.2
Sale must be non-contingent
1.3.1
Sale must be immediate
Not deferred to future
(eg property must pass 1.3.2
on sale date not on future date)
Valuable
(eg not a stone or leaf) 2.2
Specific & certain
(Muta'aiyan)
(eg currency etc.)
Credit Sale
(Istijrar)
(eg settlement at the end of the month) 1.1.2(a)
Cash sale
(Taati)
(eg as in Supermarkets)
1.1.2(b)
Unconditional contract
1.3.1(a)
Under reasonable conditions
1.3.1(b)
Under unreasonable condition but in market practice
(eg. warranty of 1 year on sale of fridge) 1.3.1(c)
Usable
(eg not a pig or alcohol)
2.3
Capable of ownership/title
(eg not sea/sky) 2.4
Capable of delivery/ possession (eg unconstructed flat having no base) 2.5
Specific & quantified
2.6
Seller must have Title & Risk
2.7

12

FIVE KHIYARS

The term khiyar refers to the option or right of the buyer & seller to rescind a contract of sale.

There are five khiyars in a sale contract which are as follows:

a. **Khiyar-e-Shart** (Optional condition): At the time of sale Buyer or Seller can put a condition that he has an option to rescind the sale within the specific 4 days. This option is called Khiyar-e-Shart.
Specification of the days is necessary for this Khiyar. Within this period, he has the right to rescind/dissolve the sale without any reason. If the buyer puts the condition, it is called Khiyar-e-Mushtari (option of buyer) and when put by the seller, it is called Khiyar-e-Bai (option of seller). This Khiyar is not transferred to heirs.

b. **Khiyar-e-Roiyyat** (Option of inspecting goods): Where the goods can be returned after inspection. This applies automatically to all contracts. Eg. 'A' buys machinery from 'B' without seeing. However, 'A' has the option to return the machinery after inspection.

c. **Khiyar-e-Aib** (Option of defect): Where the goods can be returned if found defective. It is the responsibility of the seller to supply goods free of error/defect or point out the defect to the buyer. No way is he allowed to cover the defect of the goods which constitutes as fraud. In one of the hadiths, Prophet ﷺ has stated "He is not amongst us

who indulges in fraud." Therefore the buyer has the right to return the good in case of a defect which is considered a defect in the market and which depreciates the value of the goods. Eg. 'A' buys batteries from 'B'. However, 'A' has the option to return them to 'B' if the batteries are found to be defective or not in working condition.

d. **Khiyar-e-Wasf** (Option of quality): Where the goods are sold by specifying a certain quality by the Seller but which is absent in the goods. Eg. 'A' buys a car from 'B' who has specified automatic transmission of the car. However when 'A' uses the car, he finds the transmission to be manual. Therefore he can return the car to 'B' in the absence of a specific quality.

e. **Khiyar-e-Ghaban** (Option of price): Where the seller sells the goods at a price which is far expensive than the market price, a Buyer has the right to return it to the seller. Eg. a Parker pen is sold to 'A' by 'B' at a price of Rs.500/-. However after the sale, 'A' discovers its market price to be Rs.250/-, he has the option to return the pen to 'B'.

Iqala (Recession of Contract): Where parties freely consent to rescind the contract i.e. each party will give back the consideration received by it.

Neither the buyer nor the seller has the sole right to rescind the contract after execution of a contract. Often the buyer wants to rescind the contract after buying goods. In this case, it is necessary that he gets the seller's consent. Therefore this mutual agreement between buyer and seller to rescind the contract is called Iqala.

In one of the hadiths, Prophet ﷺ has stated "He who does the Iqala (rescinding of the contract) with a Muslim who is not happy with his transaction, Allah will forgive his sins on the Day of Judgment."

However, it may be noted that the price of the goods being returned under Iqala will remain unchanged.

***Effect on third Parties**:* Iqala is treated as a new sale as if a new contract is entered into between the parties rescinding the original contract.

SECTION IV

ISLAMIC MODES OF FINANCING

13

MUSHARAKAH

Hadees-e-Qudsi
Allah Subhan-o-Tallah has declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust (*Khayanah).*

Definition and classification of Musharakah
The literal meaning of Musharakah is sharing. The root of the word "Musharakah" in Arabic is Shirkah, which means being a partner. It is used in the same context as the term "shirk" meaning partner to Allah. Under Islamic jurisprudence, Musharakah means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. It is an ideal alternative for the interest based financing with far reaching effects on both production and distribution. The connotation of this term is little limited than the term "Shirkah" more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts, it will be pertinent at the outset to explain the meaning of each term, as distinguished from the other. "Shirkah" means "Sharing" and in the terminology of Islamic Fiqh, it has been divided into two kinds:

(1) **Shirkat-ul-milk (Partnership by joint ownership)**: It means joint ownership of two or more persons in a particular property. This kind of "Shirkah" may come into existence in two different ways:

a) Optional *(Ikhtiari)*: At the option of the parties e.g., if two or more persons purchase equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called "Shirkat-ul-Milk Ikhtiari" Here this relationship has come into existence at their own option, as they themselves elected to purchase the equipment jointly.
b) Compulsory *(Ghair Ikhtiari):* This comes into operation automatically without any effort/action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.

There are two more types of Joint ownerships (Shirkat-ul-Milk):

- *Shirkat-ul-Ain*
- *Shirkat-ul-Dain*

A property in shirkat-ul-milk is jointly owned but not divided yet, is called *Musha.* In Shirkat-ul-milk undivided shares or other assets can be used in the following manner:

a) ***Mushtarik Intifa'***: Mutually or jointly using an asset by taking turns under circumstances where the partners or joint owners are on good terms.
b) ***Muhaya:*** Under this arrangement the owners will set turns in days for example one may use the product for 15 days and then the other may use it for the rest of the month.
c) ***Taqseem:*** Referring to division of the jointly owned asset. This may be applied for property where the asset that is owned can be divided permanently for example jointly taking a 1,000 sq. yards plot and making a house on 500 yards by each of the 2 owners.
d) Under a situation where the partners are not satisfied with Muhaya arrangement, the property or asset jointly held can be sold off and proceeds divided between the partners.

(2) **Shirkat-ul-Aqd (Partnership by contract)**: This is the second type of Shirkah, which means, "a partnership effected by a mutual contract". For the purpose of brevity it may also be translated as "joint commercial enterprise." Shirkat-ul-Aqd is further divided into three kinds:

(i) ***Shirkat-ul-Amwal*** (Partnership in capital) where all the partners invest some capital into a commercial enterprise.

(ii) ***Shirkat-ul-Aamal*** (Partnership in services) where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two people agree to undertake tailoring services for their customers on the condition that the wages so earned will go to a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done, this partnership will be a shirkat-ul-aamal which is also called Shirkat-ut-taqabbul or Shirkat-us-sanai or Shirkat-ul-abdan.

(iii)***Shirkat-ul-wujooh*** *(Partnership in goodwill)*. The word has its root in the Arabic word *Wajahat* meaning goodwill. Here the partners have no investment at all. They purchase commodities on deferred price, by getting capital on loan because of their goodwill and sell them at spot. The profit so earned is distributed between them at an agreed ratio.

Each of the above three types of Shirkat-ul-Aqd are further divided into two types:

a) ***Shirkat-Al-Mufawada:*** (Capital & labour at par): All partners share capital, management, profit, risk in absolute equals. It is a necessary condition for all four categories to be shared amongst the partners; if any one category is not is not shared, then the partnership becomes Shirkat-ul-Ainan. Every partner who shares equally is a Trustee, Guarantor and Agent on behalf of the other partners.

b) ***Shirkat-ul-Ainan :*** A more common type of Shirkat-ul-Aqd where equality in capital, management or liability might be equal in one case but not in all respect meaning either profit is equal but not labour or vice versa.

All these modes of "Sharing" or partnership are termed as "Shirkah" in the terminology of Islamic Fiqh, while the term "Musharakah" is not found in the books of Fiqh. This term (i.e. Musharakah) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of "Shirkah", that is, the Shirkat-ul-Amwal, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes Shirkat-ul-Aamal also where partnership takes place in the business of services.

It is evident from this discussion that the term "Shirkah" has a much wider sense than the term "Musharakah" as is being used today. The latter is limited to "Shirkat-ul-Amwal " only i.e. all the partners invest some capital into a commercial enterprise, while the former includes all types of joint ownership and those of partnership.

Rules & Conditions of Shirkat-ul-Aqd:
Common conditions are three which are as follows:

a) The existence of Muta'aqideen (Partners):
b) Capability of Partners: Must be sane & mature and be able of entering into a contract. The contract must take place with free consent of the parties without any fraud or misrepresentation.
c) The presence of the commodity: This means the price and commodity itself.

Special conditions are also three which are as follows:

a) The commodity should be capable of an Agency: The object in the contract must qualify as a commodity having value and not as a free good which is accessible to all. For example grass or wood cannot

be made the subject matter. As each partner is responsible for managing the project, therefore he will directly influence the overall profitability of the business. As a result, each member in Shirkat-ul-Aqd should duly qualify as legally being eligible of becoming an agent and of carrying on business eg. 'A' has written a book and owns it, 'B' cannot sell it unless 'A' appoints 'B' as his agent.

b) The rate of profit sharing should be determined: The share of each partner in the profit earned should be identified at the time of the contract. If however, the ratio is not determined before hand the contract becomes void (Fasid). Therefore identifying the profit share is necessary.

c) Profit & Loss Sharing: All partners will share in profit as well as loss. By placing the burden of loss solely on one or a few partners makes the partnership invalid. A condition for Shirkat-ul-Aqd is that the partners will jointly share the profit. However, defining an absolute value is not permissible, therefore only a percentage of the total return is allowed.

The basic rules of Musharakah

Musharakah or Shirkat-ul-amwal is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc.

But there are certain ingredients, which are peculiar to the contract of "Musharakah". They are summarized here:

Basic rules of Capital:

The capital in a Musharakah agreement should be:

a) *Quantified (Ma'loom)*: Meaning how much etc.

b) *Specified (Muta'aiyan):* Meaning specified currency etc.

c) *Not necessarily be merged:* The mixing of capital is not required.
d) *Not necessarily be in liquid form*: Capital share may be contributed either in cash/liquid or in the form of commodities. In case of a commodity, the market value of the commodity shall determine the share of the partner in the capital.

Management of Musharakah
The normal principle of Musharakah is that every partner has a right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the Musharakah. But in this case the sleeping partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the ratio of his investment, as discussed earlier.

However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of business. Any work done by one of them in the normal course of business shall be deemed as authorized by all partners.

Basic rules of distribution of Profit
1. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business and not in proportion to the capital invested by him. E.g. if it is agreed between them that 'A' will get 1% of his investment, the contract is not valid.
2. It is not allowed to fix a lump sum amount for anyone of the partners or any rate of profit tied up with his investment. Therefore if 'A' & 'B' enter into a partnership and it is agreed between them that 'A' shall be given Rs.10,000/- per month as his share in the profit and the rest will go to 'B', the partnership is invalid.

3. If both partners agree that each will get percentage of profit based on his capital percentage, whether both work or not, it is allowed.
4. It is also allowed that if an investor is working, his profit share (%) could be more than his capital base (%) irrespective whether the other partner is working or not. Eg. if 'A' & 'B' have invested Rs.1000/- each in a business and it is agreed that only 'A' will work and will get 2/3rd of the profit while 'B' will get 1/3rd. Similarly if the condition of work is also imposed on 'B' in the agreement, then also the proportion of profit for 'A' can be more than his investment.
5. If a partner has put an express condition in the agreement that he will not work for the Musharakah and will remain a sleeping partner throughout the term of Musharakah, then his share of profit cannot be more than the ratio of his investment. However, Hanbali school of thought considers fixing the sleeping partners share more than his investment to be permissible.
6. It is allowed that if a partner is not working, his profit share can be established as less than his capital share.
7. If both are working partners, the share of profit can differ from the ratio of investment. Eg. Zaid & Bakar both have invested Rs.1000/- each. However Zaid gets 1/3rd of the total profit and Bakar 2/3rd, this is allowed. This opinion of Imam Abu Hanifa is based on the fact that capital is not the only factor for profit but also labour and work. Therefore although the investment of two partners is the same but in some cases quantity and quality of work might differ.
8. If only a few partners are active and others are only sleeping partners, then the share in the profit of the active partner could be fixed at higher than his ratio of investment eg. 'A' & 'B' put in Rs.100 each and it is agreed that only 'A' will work, then 'A' can take more than 50% of the profit as his share. The excess he receives over his investment will be compensation for his services

Basic rules of distribution of Loss

All scholars are unanimous on the principle of loss sharing in Shariah based on the saying of Syedna Ali ibn Talib that is as follows:

"Loss is distributed exactly according to the ratio of investment and the profit is divided according to the agreement of the partners."

Therefore the loss is always subject to the ratio of investment eg. if 'A' has invested 40% of the capital and 'B' 60%, they must suffer the loss in the same ratio, not more, not less. Any condition contrary to this principle shall render the contract invalid.

Powers & Rights of Partners in Musharakah:

After entering into a Musharakah contract, partners have the following rights:

a) The right to sell the mutually owned property since all partners are representing each other in Shirkah and all have the right to buy & sell for business purposes.
b) The right to buy raw material or other stock on cash or credit using funds belonging to Shirkah to put into business.
c) The right to hire people to carry out business if needed.
d) The right to deposit money & goods of the business belonging to Shirkah as depositor trust where and when necessary.
e) The right to use Shirkah's fund or goods in Mudarabah.
f) The right of giving Shirkah's funds as hiba (gift) or loan. If one partner for purpose of investing in the business has taken a Qard-e-Hasana, then paying it becomes liable on both.

Termination of Musharakah

Musharakah will stand terminated in the following cases:

1. If the purpose of forming the Shirkah has been achieved. For example, if two partners had formed a Shirkah for a

certain project for e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, the rules are simple and clear in this case. The distribution of profit will be as per the agreed rate whereas in case of loss, each partner will bear the loss according to his ratio of investment.

2. Every partner has the right to terminate the Musharakah at any time after giving his partner a notice that will cause the Musharakah to end. For dissolving this partnership, if the assets are liquidated, they will be distributed pro-rata between the partners. However, if this is not the case, the partners may agree either:
   a) To liquidate the assets or
   b) Distribute the assets as they are.

   In case of a dispute between partners whether to seek liquidation of assets or distribute non-liquid assets, the distribution of non-liquid assets will be preferred. Because after the termination of Musharakah, all the assets are in the joint ownership of the partners and a co-owner has a right to seek partition or separation and no one can compel him on liquidation. But if the assets are in a form that cannot be distributed such as machinery, then they shall be sold and the sale-proceeds shall be distributed.
3. In case of a death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the Musharakah stands terminated.
4. In case of damage to the share capital of one partner before mixing the same in the total investment and before affecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.

Termination of Musharakah without closing the business
If one of the partners wants termination of the Musharakah, while the other partner or partners like to continue with the business, this purpose can be achieved by mutual agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of Musharakah with one partner does not imply its termination between the other partners.

However, in this case, the price of the share of the leaving partner must be determined by mutual consent. If there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the leaving partner may compel other partners on the liquidation or on the distribution of the assets themselves.

The question arises whether the partners can agree, while entering into the contract of the Musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners or the majority of them wants to do so. And that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them on liquidation or separation.

This condition may be justified, especially in the modern situations, on the ground that the nature of business, in most cases today, requires continuity for its success, and the liquidation or separation at the instance of a single partner only may cause irreparable damage to the other partners.

If a particular business has been started with huge amounts of money which has been invested in a long-term project, and one of the partners seeks liquidation in the infancy of the project, it may be fatal to the interests of the partners, as well as to the economic growth of the society, to give him such an arbitrary power of liquidation or separation. Therefore, such a condition seems to be justified, and it can be supported by

the general principle laid down by the Holy Prophet ﷺ in his famous hadith:

"All conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful".

Dispute Resolution

There shall be a provision for adjudication by a Review Committee to resolve any difference that may arise between the bank and its clients (partners) with respect to any of the provisions contained in the Musharakah Agreement.

Security in Musharakah

In case of Musharakah agreement between the Bank and the client, the bank shall in its own right and discretion, obtain adequate security from the party to ensure safety of the capital invested/ financed as also for the profit that may be earned as per profit projection given by the party. The securities obtained by the bank shall, also as usual, be kept fully insured at the party's cost and expenses till Islamic mode of insurance i.e. Takaful becomes operational. The purpose of this security is to utilize this only in case of damage or loss of the principal amount due to the negligence of the client.

The difference between interest based financing and Musharakah:

	Interest based financing	*Musharakah*
1.	A fixed rate of return on a loan advanced by the financier is predetermined irrespective of the profit earned or loss suffered by the debtor.	Musharakah does not envisage a fixed rate of return. The return is based on the actual profit earned by the joint venture.

2.	The financier cannot suffer loss.	The financier can suffer loss, if the joint venture fails to produce fruits.
3.	Results in injustice either to the creditor or to the debtor. If the debtor suffers a loss, it is unjust on the part of the creditor to claim a fixed rate of profit. Also if the debtor earns a very high rate of profit, it is injustice to the creditor to give him only small proportion of the profit leaving the rest for the debtor.	The returns of the creditor are tied up with the actual profits accrued through the enterprise. The greater the profits of the enterprise, the higher the rate of return to the creditor. If the enterprise earns enormous profits, all of it cannot be secured by the debtor exclusively but will be shared by common people e.g. Depositors in the bank.

ISSUES RELATING TO MUSHARAKAH

Musharakah is a mode of financing in Islam. Following are some issues relating to the tenure of Musharakah, redemption in Musharakah and the mixing of capital in conducting musharakah. These were discussed previously, they are explained in detail here.

LIQUIDITY OF CAPITAL

A question commonly asked in the operation of Musharakah is whether the capital invested needs to be in liquid form or not. The answer as to whether the contract in Musharakah can be based on commodities only or on money varies among the different schools of thought in Islam. For example if Zaid and Bakar agree to invest Rs.1000 each in a garment business and both keep their investments with themselves. Then if Zaid buys cloth with his investment will it be considered

belonging to both Zaid and Bakar or only to Zaid? Furthermore if the cloth is sold, can Zaid alone claim the profit or loss on the sale? In order to answer this question the prime consideration should be whether the partnership becomes effective without mixing the two investments profit or loss. This issue can be resolved in the light of the following schools of thought of different fiqhs:

Imam Malik is of the view that liquidity is not a condition for the validity of Musharakah. Therefore even if a partner contributes in kind to the partnership his share can be determined on the basis of the evaluation according to the prevalent market price at the date of the contract.

However Imam Hanifa and Imam Ahmad do not allow capital of investment to be in kind. The reason for this restriction is as follows:

- Commodities contributed by one partner will always be distinguishable from the commodities given by the other partners therefore they cannot be treated as homogenous capital.
- If in case of redistribution of share capital to the partners tracing back each partners share becomes difficult. If the share capital was in the form of commodities then redistribution cannot take place because they may have been sold at that time.

Imam Shafi has an opinion dividing commodities into two:

- ***Dhawat-ul-Amthal:*** Commodities which if destroyed can be compensated by similar commodities in quality and quantity. Exampla rice, wheat etc.
- ***Dhawat-ul-Qeemah:*** Commodities that cannot be compensated by similar commodities like animals.

Imam Shafi is of the view that commodities of the first kind may be contributed to Musharakah in the capital while the second type of commodities cannot be a part of the capital. In

case of Dhawat-ul-Amthal redistribution of capital may take place by giving to each partner the similar commodities he had invested and earlier the commodities need to be mixed so well together that the commodity of one partner cannot be distinguished from commodities contributed by the other.

Therefore, it should be remembered that the illiquid goods can be made capital of investment and the market value of the commodities shall determine the share of the partner in the capital.

MIXING OF THE CAPITAL

In case of illiquid capital being used the mixing of capital is an issue. According to Imam Shafi partners' capital should be mixed so well that it cannot be discriminated and this mixing should be done before any business is conducted. Therefore, partnership will not be completely enforceable if any kind of discrimination is present in the partners' capital. His argument is based on the reasoning that unless both investments will be mixed the investment will remain under the ownership of the original investor and any profit or loss on trade of that investment will be entitled to the original investor only. Hence such a partnership is not possible where the investment is not mixed.

According to Imam Abu Hanifa, Imam Malik and Imam Ahmed bin Hunbul the partnership is complete only with an agreement and the mixing of capital is not important. They are of the opinion that when two partners agree to form a partnership without so far mixing their capital of investment, then if one partner bought some goods for the partnership with his share of investment of Rs. 100,000, these goods will be accepted as being owned by both partners and hence any profit or loss on sale of these goods should be shared according to the partnership agreement.

However, if the share of investment of one person is lost before mixing the capital or buying anything for the

partnership business, then the loss will be borne solely by the person who's owned the capital and will not be shared by other partners. However if the capital of both had been mixed and then a part of whole had been lost or stolen the loss would have been borne by both.

Since in Hanafi, Maliki and Hanbali schools of thought mixing of the capital is not important therefore a very important present day issue is addressed with reference to this principle. If some companies or trading houses enter into partnership for setting up an industry to conduct business they need to open LC for importing the machinery. This LC reaches the importer through his bank. Now when the machinery reaches the port and the importing companies need to pay for taking possession the latter need to show those receipts in order to take possession of the goods.

Under Shafi school of thought, the imported goods cannot become the capital of investment but will remain in the ownership of the person opening the LC because at the time of opening the LC the capital has not been mixed and without mixing the capital Musharakah cannot come into existence. Under this situation if the goods are lost during shipment the burden of loss will fall upon the opener of the LC, even though the goods were being imported for the entire industry. This is because even though a group of companies had asked for the machinery or imported goods the importers had not mixed their capital at the time of investment.

Contrary to this since the other three schools of thought believe that partnership comes into existence at the time of agreement rather than after the capital has been mixed therefore the burden of loss will be borne by all. This has two advantages:

a) In case of loss the burden of loss will not fall upon one rather will be shared by all firms of the partner.

b) If the capital is provided at the time of the agreement it stays blocked for the period during which the machinery is being imported. While if the capital was not kept idle, till the actual operation could be conducted with the machinery the same capital could have been used for something else as well.

This shows that the decision of the three combined schools of thought is better equipped to handle the current import export situation.

TENURE OF MUSHARAKAH

For conducting a Musharakah agreement, questions arise pertaining to fixing the period of the agreement. For fixing the tenure of the Musharakah following conditions should be remembered:

a) The partnership is fixed for such a long time that at the end of the tenure no other business can be conducted.

b) Can be for a very short time period during which partnership is necessary and neither partner can dissolve the partnership.

Under the Hanafi school of thought a person can fix the tenure of the partnership because it is an agreement and an agreement should have a fixed period of time.

In the Hanbal school of thought the tenure can be fixed for the partnership as it's an agency agreement and an agency agreement in this school can be fixed. The Maliki school however says that Shirkah cannot be subjected to a fixed tenure. Shafi school like the Maliki consider fixing the tenure to be not permissible. Their argument is that fixing the period will prohibit conducting the business at the end of that period which in turn means that the fixing will prevent them from conducting the business.

Uses Of Musharakah / Mudarabah :

These modes can be used in the following areas (or can replace them according to Shariah rules).

Asset Side Financing

- Short/medium/long - term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Import bills drawn under import letters of credit
- Inland bills drawn under inland letters of credit
- Bridge financing
- LC without margin (for Mudarba)
- LC with margin (for Musharakah)
- Export financing (Pre-shipment financing)
- Working capital Financing
- Running accounts financing / short term advances

Liability Side Financing

- For current/ saving/mahana amdani/ investment ccounts (deposit giving Profit based on Musharkah/Mudarbah – with predetermined ratio)
- Inter- Bank lending / borrowing
- Term Finance Certificates & Certificate of Investment
- T-Bill and Federal Investment Bonds / Debenture.
- Securitization for large projects (based on Musharkah)
- Certificate of Investment based on Murabahah (Eg: Al Meezan Riba Free)
- Islamic Musharakah bonds (based on projects requiring large amounts – profit based on the return from the project)

14

MUDARABAH

Glossary:

Mudarib	:	Working Partner (brings effort)
Ras-ul-Maal	:	Investment
Rab-ul-Maal	:	Investor (brings capital)
Wakeel	:	Agent
Ameen	:	Trustee
Kafeel	:	Guarantor

Definition:

This is a kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner who is called *"Rab-ul-Maal"* while the management and work is an exclusive responsibility of the other, who is called *"Mudarib"* and the profits generated are shared in a predetermined ratio.

Types of *Mudarabah*

There are 2 types of *Mudarabah* namely:

1. *Al Mudarabah Al Muqayyadah*: *Rab-ul-Maal* may specify a particular business or a particular place for the *mudarib*, in which case he shall invest the money in that particular business or place. This is called Al *Mudarabah Al Muqayyadah* (restricted *Mudarabah*).

2. *Al Mudarabah Al Mutlaqah*: However if *Rab-ul-maal* gives full freedom to *Mudarib* to undertake whatever business he deems fit, this is called *Al Mudarabah Al Mutlaqah* (unrestricted *Mudarabah*). However *Mudarib* cannot, without the consent of *Rab-ul-Maal*, lend money to anyone. *Mudarib* is authorized to do anything, which is normally done in the course of business. However if they want to have an extraordinary work, which is beyond the normal routine of the traders, he cannot do so without express permission from *Rab-ul-Maal*. He is also not authorized to:

   a) keep another *Mudarib* or a partner
   b) mix his own investment in that particular Modarabah without the consent of *Rab-ul Maal*.

   Conditions of Offer & Acceptance are applicable to both. A *Rab-ul-Maal* can contract *Mudarabah* with more than one person through a single transaction. It means that he can offer his money to 'A' and 'B' both so that each one of them can act for him as *Mudarib* and the capital of the *Mudarabah* shall be utilized by both of them jointly, and the share of the *Mudarib*.

Difference between *Musharakah* and *Mudarabah*

	Musharakah	***Mudarabah***
1.	All partners invest.	Only *Rab-ul-Maal* invests.
2.	All partners participate in the management of the business and can work for it.	*Rab-ul-maal* has no right to participate in the management which is carried out by the *Mudarib* only.
3.	All partners share the loss to the extent of the ratio of their investment.	Only *Rab-ul-maal* suffers loss because the *Mudarib* does not invest anything. However this is subject to a condition that the *Mudarib*

		has worked with due diligence.
4.	The liability of the partners is normally unlimited. If the liabilities of business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne pro rata by all partners. But if the partners agree that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition.	The liability of *Rab-ul-maal* is limited to his investment unless he has permitted the *Mudarib* to incur debts on his behalf.
	As soon as the partners mix up their capital in a joint pool, all the assets become jointly owned by all of them according to the proportion of their respective investment. All partners benefit from the appreciation in the value of the assets even if profit has not accrued through sales.	The goods purchased by the *Mudarib* are solely owned by *Rab-ul-maal* and the *Mudarib* can earn his share in the profit only in case he sells the goods profitably.

Investment

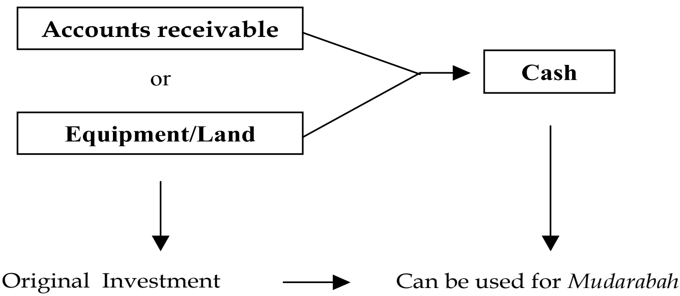
In *Mudarabah, Rab-ul-maal* provides the investment and *Mudarib* the management therefore the *Rab-ul-maal* should hand over the agreed investment to *Mudarib* and leaves everything to *Mudarib* with no interference from his side but he has the authority to:

a) Oversee the *Mudarib's* activities and
b) Work with *Mudarib* if the *Mudarib* consents.

In what form should the capital be? Should it be liquid or non-liquid assets like equipment, land etc. can these form a capital?

The basic principle is that the capital in *Mudarabah* is valid just the way as it is in *Shirkah* which according to Hanafi fiqh should be in liquid form but according to other scholars equipment, land etc can also be included as capital. However all agree on the following:

Assets other than cash can be used as an intermediate step, meaning:



However this is subject to the determination of exact amount of the assets before it is used for *Mudarabah*. If the assets are not correctly evaluated, the *Mudarabah* is not valid.

Mudarabah Expenses

The *Mudarib* shares profit of the *Mudarabah* as per agreed rate with the investor but his expenses like meals, clothing, conveyance and medical are not borne by *Mudarabah*. However, if he is traveling on business and is overstaying the night, then the above expenses shall be covered from capital. If *Mudarib* goes for a journey which constitutes *Safar-e-Sharai* (more than 48 miles) but does not overstay the night, his expenses will not be borne by *Mudarabah*.

All expenses which are incidental to the *Mudarabah's* function like wages of employees/workers or Commission in buying/selling or stitching, dyeing expenses etc have to be paid by the *Mudarabah*. However all expenses will be included in the cost of commodities which *Mudarib* is selling for eg. if he is selling ready made garments then the stitching, dyeing, washing expenses etc. can be included by the *Mudarib* in the total cost of the garments.

If the *Mudarib* manages the *Mudarabah* within his city , he will not be allowed any expenses, only his profit share. Similarly, if he keeps an employee, this employee will not be allowed any expenses, just his salary.

If the *Mudarabah* agreement becomes *Fasid* due to any reason, the *Mudarib's* status will be like an employee, meaning:

a) whether he is traveling or doing business in his city, will not be entitled to any expense such as meals, conveyance, clothing, medicine etc.

b) he will not be sharing any profit and will just get *Ujrat-e-Misl* (ordinary pay) for his job.

UJRAT-E-MISL (The salary or wage of Mudarib according to the market value of that work. It should not exceed the profit share under the correct Mudarabah.)	→	Can be given in void Mudarabah when it has produced profit but if it fails to produce profit, Ujrat-e-Misl will not be given.

Distribution of Profit & Loss

It is necessary for the validity of *Mudarabah* that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. The Shariah has prescribed no particular proportion; rather it has been left to their mutual consent. They can share the profit in equal proportions and they can also allocate different proportions for *Rab-ul-Maal* and *Mudarib*. However in extreme case where the parties have not predetermined the ratio of profit, the profit will be calculated at 50:50.

The *Mudarib* & *Rab-ul-Maal* cannot allocate a lump sum amount of profit for any party nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs.100,000/-, they cannot agree on a condition that Rs.10,000 out of the profit shall be the share of the *Mudarib* nor can they say that 20% of the capital shall be given to *Rab-ul-Maal*. However they can agree that 40% of the actual profit shall go to the *Mudarib* and 60% to the *Rab-ul-Maal* or vice versa.

It is also allowed that different proportions are agreed in different situations. For example, the *Rab-ul-Maal* can say to *Mudarib* "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30% of the profit and if you do it in another town, your share will be 50% of the profit".

Apart from the agreed proportion of the profit, as determined in the above manner, the *Mudarib* cannot claim any periodical salary or a fee or remuneration for the work done by him for the *Mudarabah*.

All schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the *Mudarib* to draw his daily expenses of food only from the *Mudarabah* Account. The Hanafi jurists restrict this right of the *Mudarib* only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc. but he is not entitled to get anything as daily allowances when he is in his own city.

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

The *Mudarabah* becomes void (*Fasid*) if the profit is fixed in any way. In this case, the entire amount (Profit + Capital) will be the *Rab-ul-Maal's*. The *Mudarib* will just be an employee earning *Ujrat-e-Misl*.

The remaining amount will be called (Profit).

This profit will be shared in the agreed (pre-agreed) ratio.

Roles of the Mudarib:

Ameen (Trustee):	To look after the investment responsibly, except in case of natural calamities.
Wakeel (Agent) :	To purchase from the funds provided by *Rab-ul-Maal*
Shareek (Partner):	Sharing in any profit
Zamin (Liable):	To provide for the loss suffered by the *Mudarabah* due to any act on his part.

Ajeer (Employee): When the *Mudarabah* gets *Fasid* due to any reason, the *Mudarib* is entitled to only the salary, *Ujrat-e-Misl*.

In case there is a loss, the *Mudarib* will not even get the *Ujrat-e-Misl*.

Termination of *Mudarabah*

The *Mudarabah* will stand terminated when the period specified in the contract expires. It can also be terminated any time by either of the two parties by giving notice. In case *Rab-ul-Maal* has terminated services of *Mudarib*, he will continue to act as *Mudarib* until he is informed of the same and all his acts will form part of *Mudarabah*.

If all assets of the *Mudarabah* are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of *Mudarabah* are not in cash form, it will be sold and liquidated so that the actual profit may be determined. All loans and payables of *Mudarabah* will be recovered. The provisional profit earned by *Mudarib* and *Rab-ul-Maal* will also be taken into account and when total capital is drawn, the principal amount invested by *Rab-ul-Maal* will be given to him, balance will be called profit which will be distributed between *Mudarib* and *Rab-ul-Maal* at the agreed ratio. If no balance is left, *Mudarib* will not get anything. If the principal amount is not recovered fully, then the profit shared by *Mudarib* and *Rab-ul-Maal* during the term of Mudarabah will be withdrawn to pay the principal amount to *Rab-ul-Maal*. The balance will be profit, which will be distributed between *Mudarib* and *Rab-ul-Maal*. In this case too if no balance is left, *Mudarib* will not get anything.

Uses Of Musharakah / Mudarabah :

These modes can be used in the following areas (or can replace them according to Shariah rules).

Asset Side Financing

- Short/medium/long - term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Import bills drawn under import letters of credit
- Inland bills drawn under inland letters of credit
- Bridge financing
- LC without margin (for Mudarba)
- LC with margin (for Musharakah)
- Export financing (Pre-shipment financing)
- Working capital financing
- Running accounts financing / short term advances

Liability Side Financing

- For current /saving/mahana amdani/investment accounts (deposit giving Profit based on Musharkah / Mudarabah – with predetermined ratio)
- Inter- Bank lending / borrowing
- Term Finance Certificates & Certificate of Investment
- T-Bill and Federal Investment Bonds / Debenture.
- Securitization for large projects (based on Musharkah)
- Certificate of Investment based on Murabahah (Eg: Al Meezan Riba Free)
- Islamic Musharakah bonds (based on projects requiring large amounts – profit based on the return from the project)

15

DIMINISHING MUSHARAKAH

Another form of *Musharakah*, developed in the near past, is 'Diminishing *Musharakah*'. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share until all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.

The Diminishing *Murabahah* based on the above concept has taken different shapes in different transactions. Some examples are given below:

1. It has been used mostly in house financing. The client wants to purchase a house for which he does not have adequate funds. He approaches the financier who agrees to participate with him in purchasing the required house. 20% of the price is paid by the client and 80% of the price by the financier. Thus, the financier owns 80% of the house while the client owns 20%. After purchasing the property jointly, the client uses the house for his residential requirement and pays rent to the financier for using his share in the property. At the same time, the share of financier is

further divided in eight equal units, each unit representing 10% ownership of the house. The client promises to the financier that he will purchase one unit after three months. Accordingly, after the first term of three months he purchases one unit of the share of the financier by paying 1/10th of the price of the house. It reduces the share of the financier from 80% to 70%. Hence, the rent payable to the financier is also reduced to that extent. At the end of the second term, he purchases another unit increasing his share in the property to 40% and reducing the share of the financier to 60% and consequently reducing the rent to that proportion. This process goes on in the same fashion until after the end of two years, the client purchases the whole share of the financier reducing the share of the financier to 'zero' and increasing his own share to 100%.

This arrangement allows the financier to claim rent according to his proportion of ownership in the property and at the same time allows him periodical return of a part of his principal through purchases of the units of his share.

2. 'A' wants to purchase a taxi to use it for offering transport services to passengers and to earn income through fares recovered from them, but he is short of funds. 'B' agrees to participate in the purchase of the taxi, therefore, both of them purchase a taxi jointly. 80% of the price is paid by 'B' and 20% is paid by 'A'. After the taxi is purchased, it is employed to provide transport to the passengers whereby the net income of Rs. 1000/- is earned on daily basis. Since 'B' has 80% share in the taxi, it is agreed that 80% of the fare will be given to him and the rest of 20% will be retained by 'A' who has a 20% share in the taxi. It means that Rs. 800/- is earned by 'B' and Rs. 200/- by 'A' on daily basis. At the same time the share of 'B' is further

divided into eight units. After three months 'A' purchases one unit from the share of 'B'. Consequently the share of 'B' is reduced to 70% and share of 'A' is increased to 30% meaning thereby that as from that date 'A' will be entitled to Rs. 300/- from the daily income of the taxi and 'B' will earn Rs. 700/-. This process will go on until after the expiry of two years, the whole taxi will be owned by 'A' and 'B' will take back his original investment along with income distributed to him as aforesaid.

3. 'A' wishes to start the business of ready-made garments but lacks the required funds for that business. 'B' agrees to participate with him for a specified period, say two years. 40% of the investment is contributed by 'A' and 60% by 'B'. Both start the business on the basis of *Musharakah*. The proportion of profit allocated for each one of them is expressly agreed upon. But at the same time 'B's share in the business is divided to six equal units and 'A' keeps purchasing these units on gradual basis until after the end of two years 'B' comes out of the business, leaving its exclusive ownership to 'A'. Apart from periodical profits earned by 'B', he gains the price of the units of his share which, in practical terms, tend to repay to him the original amount invested by him.

Analyzed from the *Shariah* point of view this arrangement is composed of different transactions, which come to play their role at different stages. Therefore, each one of the foregoing three forms of diminishing *Musharakah* is discussed below in the light of the Islamic principles:

House financing on the basis of diminishing *Musharakah*

The proposed arrangement is composed of the following transactions:

1. To create joint ownership in the property (*Shirkat-ul-Milk*).
2. Giving the share of the financier to the client on rent.
3. Promise from the client to purchase the units of share of the financier.
4. Actual purchase of the units at different stages.
5. Adjustment of the rental according to the remaining share of the financier in the property.

Steps in detail of the arrangement

i) The first step in the above arrangement is to create a joint ownership in the property. It has already been explained in the beginning of this chapter that '*Shirkat-ul-Milk*' (joint ownership) can come into existence in different ways including joint purchase by the parties. All schools of Islamic jurisprudence have expressly allowed this. Therefore no objection can be raised against creating this joint ownership.

ii) The second part of the arrangement is that the financier leases his share in the house to his client and charges rent from him. This arrangement is also above board because there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party its permissibility is a point of difference between the Muslim jurists. Imam Abu Hanifa and Imam Zufar are of the view that the undivided share cannot be leased out to a third party, while Imam Malik and Imam Shafi'i, Abu Yusuf and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. But so far as the property is leased to the partner himself, all of them are unanimous on the validity of '*Ijarah*'.

iii) The third step in the aforesaid arrangement is that the client purchases different units of the undivided share of the financier. This transaction is also allowed. If the undivided share relates to both land and building, the sale of both is allowed according to all the Islamic schools. Similarly if the undivided share of the building is intended to be sold to the partner, it is also allowed unanimously by all the Muslim jurists. However, there is a difference of opinion if it is sold to the third party.

It is clear from the foregoing three points that each one of the transactions mentioned herein above is allowed, but the question is whether this transaction may be combined in a single arrangement. The answer is that if all these transactions have been combined by making each one of them a condition to the other, then this is not allowed in *Shariah*, because it is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another.

However, the proposed scheme suggests that instead of making two transactions conditional to each other, there should be one sided promise from the client, firstly, to take share of the financier on lease and pay the agreed rent, and secondly, to purchase different units of the share of the financier of the house at different stages. This leads us to the fourth step, which is the enforceability of such a promise.

iv) It is generally believed that a promise to do something creates only a moral obligation on the promisor, which cannot be enforced through courts of law. However, there are a number of Muslim jurists who declare that promises are enforceable, and the court of law

> can compel the promisor to fulfill his promise, especially, in the context of commercial activities. Some Maliki and Hanafi jurists can be cited, in particular, who have declared that the promises can be enforced through courts of law in cases of need. The Hanafi jurists have adopted this view with regard to a particular sale called '*bai-bilwafa*'. This *bai-bilwafa* is a special arrangement of sale of a house whereby the buyer promises to the seller that whenever the latter gives him back the price of the house, he will resell the house to him. This arrangement was in vogue in countries of central Asia, and the Hanafi jurists have declared that if the resale of the house to the original seller is made a condition for the initial sale, it is not allowed. However, if the first sale is effected without any condition, but after effecting the sale the buyer promises to resell the house whenever the seller offers to him the same price, this promise is acceptable and it creates not only a moral obligation, but also an enforceable right of the original seller. The Muslim jurists allowing this arrangement have based their view on the principle that "the promise can be made enforceable at the time of need".

Even if the promise has been made before effecting the first sale, after which the sale has been effected without a condition, it is also allowed by certain Hanafi jurists.

One may raise an objection that if the promise of resale has been taken before entering into an actual sale, it practically amounts to putting a condition on the sale itself, because the promise is understood to have been entered into between the parties at the time of sale, and therefore, even if the sale is without an express condition,

it should be taken as conditional because a promise in an express term has preceded it.

This objection can be answered by saying that there is a big difference between putting a condition in the sale and making a separate promise without making it a condition. If the condition is expressly mentioned at the time of sale, it means that the sale will be valid only if the condition is fulfilled, meaning thereby that if the condition is not fulfilled in future, the present sale will become void. This makes the transaction of sale contingent on a future event, which may or may not occur. It leads to uncertainty *(Gharar)* in the transaction, which is totally prohibited in *Shariah*.

Conversely, if the sale is without any condition, but one of the two parties has promised to do something separately, then the sale cannot be held to be contingent or conditional with fulfilling of the promise. It will take effect irrespective of whether or not the promisor fulfills his promise. Even if the promisor backs out of his promise, the sale will remain effective. The most the promisee can do is to compel the promisor through court of law to fulfill his promise and if the promisor is unable to fulfill the promise, the promisee can claim actual damages he has suffered because of the default.

This makes it clear that a separate and independent promise to purchase does not render the original contract conditional or contingent. Therefore, it can be enforced.

On the basis of this analysis, diminishing *Musharakah* may be used for House Financing with following conditions:

a) The agreement of joint purchase, leasing and selling different units of the share of the financier should not be tied-up together in one single contract. However, the joint purchase and the

contract of lease may be joined in one document whereby the financier agrees to lease his share, after joint purchase, to the client. This is allowed because, as explained in the relevant chapter, *Ijarah* can be affected for a future date. At the same time the client may sign one-sided promise to purchase different units of the share of the financier periodically and the financier may undertake that when the client will purchase a unit of his share, the rent of the remaining units will be reduced accordingly.

b) At the time of the purchase of each unit, sale must be affected by the exchange of offer and acceptance at that particular date.

c) It will be preferable that the purchase of different units by the client is affected on the basis of the market value of the house as prevalent on the date of purchase of that unit, but it is also permissible that a particular price is agreed in the promise of purchase signed by the client.

Diminishing *Musharakah* for carrying business of services:

The second example given above for diminishing *Musharakah* is the joint purchase of a taxi run for earning income by using it as a hired vehicle. This arrangement consists of the following ingredients:

a) Creating joint ownership in a taxi in the form of *Shirkat ul-Milk*. As already stated, this is allowed in *Shariah.*

b) *Musharakah* in the income generated through the services of the taxi. It is also allowed as mentioned earlier in this chapter.

c) Purchase of different units of the share of the financier by the client. This is again subject to the conditions already detailed in the case of House financing. However, there is

a slight difference between House financing and the arrangement suggested in this second example. The taxi, when used as a hired vehicle, normally depreciates in value over time, therefore, depreciation in the value of the taxi must be kept in mind while determining the price of different units of the share of the financier.

Diminishing *Musharakah* in Trade

The third example of diminishing *Musharakah* as given above is that the financier contributes 60% of the capital for launching a business of ready-made garments, for example. This arrangement is composed of two ingredients only:

1) In the first place, the arrangement is simply a *Musharakah* whereby two partners invest different amounts of capital in a joint enterprise. This is obviously permissible subject to the conditions of *Musharakah* already spelled out earlier in this chapter.

2) Purchase of different units of the share of the financier by the client. This may be in the form of a separate and independent promise by the client. The requirements of *Shariah* regarding this promise are the same as explained in the case of House financing with one very important difference. Here the price of units of the financier cannot be fixed in the promise to purchase, because if the price is fixed before hand at the time of entering into *Musharakah*, it will practically mean that the client has ensured the principal invested by the financier with or without profit, which is strictly prohibited in the case of *Musharakah*. Therefore, there are two options for the financier about fixing the price of his units to be purchased by the client. One option is that he agrees to sell the units on the basis of valuation of the business at the time of the purchase of each unit. If the value of the business

has increased, the price will be higher and if it has decreased the price will be less. Such valuation may be carried out in accordance with the recognized principles through the experts, whose identity may be agreed upon between the parties when the promise is signed. The second option is that the financier allows the client to sell these units to any body else at whatever price he can, but at the same time he offers a specific price to the client, meaning thereby that if he finds a purchaser of that unit at a higher price, he may sell it to him, but if he wants to sell it to the financier, the latter will be agreeable to purchase it at the price fixed by him before hand.

Although both these options are available according to the principles of *Shariah*, the second option does not seem to be feasible for the financier, because it would lead to injecting new partners in the *Musharakah* which will disturb the whole arrangement and defeat the purpose of Diminishing *Musharakah* in which the financier wants to get his money back within a specified period. Therefore, in order to implement the objective of Diminishing *Musharakah*, only the first option is practical.

Uses:

- All Purchase of Fixed Assets
- House Financing
- Plant & Factory Financing
- Car / Transport Financing
- Project Financing of fixed assets.

16

MURABAHA

Murabaha is one of the most commonly used modes of financing by Islamic Banks and financial institutions.

Definition

Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit thereon. Thus, *Murabahah* is not a loan given on interest; it is a sale of a commodity for cash/deferred price.

The *Bai' Murabahah* involves purchase of a commodity by a bank on behalf of a client and its resale to the latter on cost-plus-profit basis. Under this arrangement the bank discloses its cost and profit margin to the client. In other words rather than advancing money to a borrower, which is how the system would work in a conventional banking agreement, the bank will buy the goods from a third party and sell those goods on to the customer for a pre-agreed price.

Murabahah is a mode of financing as old as *Musharakah*. Today in Islamic banks world-over 66% of all investment transactions are through *Murabahah*.

Difference between *Murabahah* and Sale

A simple sale in Arabic is called *Musawamah* - a bargaining sale without disclosing or referring to what the cost price is.

However when the cost price is disclosed to the client it is called *Murabahah*. A simple *Murabahah* is one where there is cash payment and *Murabahah Muajjal* is one on deferred payment basis.

Arguments against *Murabahah*

An argument that arises in *Murabahah* is that profit or interest both are the same and *Murabahah* financing is the same as conventional banking. Islamic scholars however argue that in several respects a *Murabahah* financing structure is quite different to an overdraft organized along conventional lines and the former offers several benefits to the bank and its customers. Depositors are made to share in profits of the bank as a result of this financing. The basic difference is however the *Aqd* or the contract which covers the Islamic conditions. If the contract has interest element then it will be void.

Basic rules for *Murabahah*

Following are the rules governing a *Murabahah* transaction:

1. The subject of sale must exist at the time of the sale. Thus anything that may not exist at the time of sale cannot be sold and its non-existence makes the contract void.
2. The subject matter should be in the ownership of the seller at the time of sale. If he sells something that he has not acquired himself then the sale becomes void.
3. The subject of sale must be in physical or constructive possession of the seller when he sells it to another person. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity yet it has come into his control and all rights and liabilities of the commodity are passed on to him including the risk of its destruction.
4. The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. For example, 'A' tells 'B' on 1st January that he will sell his car on 1st February to 'B', the sale is void

because it is attributed to a future date.

5. The subject matter should be a property having value. Thus a good having no value cannot be sold or purchased.
6. The subject of sale should not be a thing used for an un-Islamic purpose.
7. The subject of sale must be specifically known and identified to the buyer. For Example, 'A' owner of an apartment building says to 'B' that he will sell an apartment to 'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed to the buyer.
8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.
9. The certainty of price is a necessary condition for the validity of the sale. If the price is uncertain, the sale is void.
10. The sale must be unconditional. A conditional sale is invalid unless the condition is recognized as a part of the transaction according to the usage of the trade.

Step by step *Murabahah* Financing

1. The client and the institution sign an overall agreement whereby the institution promises to sell and the client promises to buy the commodity from time to time on an agreed ratio of profit added to the cost. This agreement may specify the limit up-to which the facility may be availed.
2. An agency agreement is signed by both parties in which the institution appoints the client as his agent for purchasing the commodity on its behalf.
3. The client purchases the commodity on behalf of the institution and takes possession as the agent of the institution.
4. The client informs the institution that it has purchased the commodity and simultaneously makes an offer to purchase it from the institution.

5. The institution accepts the offer and the sale is concluded whereby ownership as well as risk is transferred to the client.

All the above conditions are necessary to effect a valid *Murabahah*. If the institution purchases the commodity directly from the supplier, it does not need any agency agreement.

The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage.

The above is the only way by which this transaction is distinguished from an ordinary interest-based transaction.

Issues in *Murabahah*

Following are some of the issues in *Murabahah* financing:

1. **Securities against *Murabahah***
   Payments coming from the sale are receivables and for this, the client may be asked to furnish a security. It can be in the form of a mortgage or hypothecation or some kind of lien or charge.

2. **Guaranteeing the *Murabahah***
   The seller can ask the client to furnish a 3rd party guarantee. In case of default on payment the seller may have recourse to the guarantor who will be liable to pay the amount guaranteed to him. There are two issues relating to this:

   a) The guarantor cannot charge a fee from the original client. The reason being that a person charging a fee for advancing a loan comes under the definition of *riba*.
   b) However the guarantor can charge for any documentation expenses.

3. **Penalty of default**

   Another issue with *Murabahah* is that if the client defaults in payment of the price at the due date, the price cannot be changed nor can penalty fees be charged.

   In order to deal with dishonest clients who default in payment deliberately, they should be made liable to pay compensation to the Islamic Bank for the loss suffered on account of default. However these should be made subject to the following conditions:

   a) The defaulter may be given a grace period of at-least one-month.
   b) If it is proven beyond doubt that the client is defaulting without valid excuse then compensation can be demanded.

4. **Rollover in *Murabahah***

   Murabahah transaction cannot be rolled over for a further period as the old contract ends. It should be understood that *Murabahah* is not a loan rather the sale of a commodity, which is deferred to a specific date. Once this commodity is sold, its ownership transfers from the bank to the client and it is therefore no more a property of the seller. Now what the seller can claim is only the agreed price and therefore there is no question of effecting another sale on the same commodity between the same parties.

5. **Rebate on earlier payments**

   Sometimes the debtors want to pay early to get discounts. However in Islam, majority of Muslim Scholars including the major schools of thought consider this to be un-Islamic. However if the Islamic bank or financial institution gives somebody a rebate on its own, it is not objectionable especially if the client is needy.

6. **Calculation of cost in *Murabahah***
   The *Murabahah* can only be effected when the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained then *Murabahah* cannot take place. In this case the sale will take place as *Musawamah* i.e. sale without reference to cost.

7. **Subject matter of the sale**
   All commodities cannot be the subject matter in *Murabahah* because certain requirements need to be fulfilled. The shares of a lawful company can be sold or purchased on *Murabahah* basis because according to the principles of Islam the shares represent ownership into assets of the company provided all other basic conditions of the transaction are fulfilled. A buy back arrangement or selling without taking their possession is not allowed at all.

   Murabahah is not possible on things that cannot become the subject of sale. For example, *Murabahah* is not possible in exchange of currencies.

Basic mistakes in *Murabahah* Financing

Some basic mistakes that can be made in practical implications of the concept are as follows:

1. The most common mistake is to assume that *Murabahah* can be used for all types of transactions and financing. This mode can only be used when a commodity is to be purchased by the customer. If funds are required for some other purpose *Murabahah* cannot be used.

2. The document is signed for obtaining funds for a specific commodity and therefore it is important to study the subject matter of the *Murabahah*.

3. In some cases, the sale of commodity to the client is

affected before the commodity is acquired from the supplier. This occurs when the various stages of the *Murabahah* are skipped and the documents are signed all together. It is to be remembered that *Murabahah* is a package of different contracts and they come into play one after another at their respective stages.

4. It is observed in some financial institutions that *Murabahah* is applied on already purchased commodities, which is not allowed in *Shariah* and can be effected on not yet purchased commodities.

Uses of Murabahah:

Murabahah can be used in following conditions:

Short / Medium / Long Term Finance for:

- Raw material
- Inventory
- Equipment
- Asset financing
- Import financing
- Export financing (Pre-shipment)
- Consumer goods financing
- House financing
- Vehicle financing
- Land financing
- Shop financing
- PC financing
- Tour package financing
- Education package financing
- All other services that can be sold in the form of package (i.e. services like education, medical etc. as a package)
- Securitization of Murabahah agreement (certificate) is allowed at par value only. Other wise certain rules of Islamic Finance must be met.

Bai' Muajjal

Bai' Muajjal is the Arabic acronym for "sale on deferred payment basis". The deferred payment becomes a loan payable by the buyer in a lump sum or installment (as agreed between the two parties). In *Bai' Muajjal* all those items can be sold on deferred payment basis which come under the definition of capital where quality does not make a difference but the intrinsic value does. Those assets do not come under definition of capital where quality can be compensated for by the price and *Shariah* scholars have an '*ijmah*' (consensus) that demanding a high price in deferred payment in such a case is permissible.

Conditions for *Bai' Muajjal*

1. The price to be paid must be agreed and fixed at the time of the deal. It may include any amount of profit without qualms about *riba*.

2. Complete/total possession of the object in question must be given to the buyer, while the deferred price is to be treated as debt against him.

3. Once the price is fixed, it cannot be decreased in case of earlier payment nor can it be increased in case of default.

4. In order to secure the payment of price, the seller may ask the buyer to furnish a security either in the form of mortgage or in the form of an item.

5. If the commodity is sold on installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date, the remaining installments will become due immediately.

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SALAM

Glossary

Rabb-us-salam	:	Buyer
Muslam ilaih	:	Seller
Ra's-ul-maal	:	Cash price
Muslam fih	:	Purchased commodity

This mode of financing can be used by the modern banks and financial institutions especially to finance the agricultural sector. In *Salam*, the seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The price is in cash but the supply of purchased goods is deferred.

Purpose of use:

- To meet the need of small farmers who need money to grow their crops and to feed their family up to the time of harvest. When Allah declared *Riba* haram, the farmers could not take usurious loans. Therefore Holy Prophet ﷺ allowed them to sell their agricultural products in advance.

- To meet the need of traders for import and export business. Under *Salam*, it is allowed for them that they sell the goods in advance so that after receiving their cash price, they can easily undertake the aforesaid business. *Salam* is beneficial to the seller because he received the price in advance and it was beneficial to the buyer also because normally the price in *Salam* is lower than the price in spot sales.

The permissibility of *Salam* is an exception to the general rule that prohibits forward sale and therefore it is subject to strict conditions, which are as follows:

Conditions of *Salam*:

1. It is necessary for the validity of *Salam* that the buyer pays the price in full to the seller at the time of effecting the sale. In the absence of full payment, it will be tantamount to sale of a debt against a debt, which is expressly prohibited by the Holy Prophet ﷺ. Moreover the basic wisdom for allowing *Salam* is to fulfill the "instant need" of the seller. If its not paid in full, the basic purpose will not be achieved.

2. Only those goods can be sold through a *Salam* contract in which the quantity and quality can be exactly specified eg. precious stones cannot be sold on the basis of *Salam* because each stone differ in quality, size, weight and their exact specification is not possible.

3. *Salam* cannot be effected on a particular commodity or on a product of a particular field or farm eg. Supply of wheat of a particular field or the fruit of a particular tree since there is a possibility that the crop is destroyed before delivery and given such possibility, the delivery remains uncertain.

4. All details in respect to quality of goods sold must be expressly specified leaving no ambiguity, which may lead to a dispute.

5. It is necessary that the quantity of the commodity is agreed upon in absolute terms. It should be measured or weighed in its usual measure only, meaning what is normally weighed cannot be quantified and vice versa.

6. The exact date and place of delivery must be specified in the contract.

7. *Salam* cannot be effected in respect of things, which must be delivered at spot.

8. The commodity for *Salam* contract should remain in the market right from the day of contract up to the date of delivery or at least till the date of delivery.

9. The time of delivery should be at least fifteen days or one month from the date of agreement. Price in *Salam* is generally lower than the price in spot sale. The period should be long enough to affect prices. But Hanafi Fiqh did not specify any minimum period for the validity of *Salam*. It is all right to have an earlier date of delivery if the seller consents to it.

10. Since price in *Salam* is generally lower than the price in spot sale; the difference in the two prices may be a valid profit for the Bank.

11. A security in the form of a guarantee, mortgage or hypothecation may be required for a *Salam* in order to ensure that the seller delivers.

12. The seller at the time of delivery delivers commodities and not money to the buyer who would have to establish a special cell for dealing in commodities.

Benefits:

There are two ways of benefiting from the contract of *Salam*:

1. After purchasing a commodity by way of *Salam*, the financial institution can sell it through a parallel contract of *Salam* for the same date of delivery. The period of *Salam* in the second parallel contract is shorter and the price is higher than the first contract. The difference between the two prices shall be the profit earned by the

institution. The shorter the period of *Salam*, the higher the price and the greater the profit. In this way institutions can manage their short term financing portfolios.

2. The institution can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. The buyer does not have to pay the price in advance. When the institution receives the commodity, it can sell it at a pre-determined price to a third party according to the terms of the promise.

Parallel *Salam*

1. In an arrangement of parallel *Salam* there must be two different and independent contracts; one where the bank is a buyer and the other in which it is a seller. The two contracts cannot be tied up and performance of one should not be contingent on the other. For example, if 'A' has purchased from 'B' 1000 bags of wheat by way of *Salam* to be delivered on 31 December, 'A' can contract a parallel *Salam* with 'C' to deliver to him 1000 bags of wheat on 31 December. But while contracting Parallel *Salam* with 'C', the delivery of wheat to 'C' cannot be conditioned with taking delivery from 'B'. Therefore, even if 'B' did not deliver wheat on 31 December, 'A' is duty bound to deliver 1000 bags of wheat to 'C'. He can seek whatever recourse he has against 'B', but he cannot rid himself from his liability to deliver wheat to 'C'. Similarly, if 'B' has delivered defective goods, which do not conform to the agreed specifications, 'A' is still obligated to deliver the goods to 'C' according to the specifications agreed with him.

2. A *Salam* arrangement cannot be used as a buy back facility where the seller in the first contract is also the purchaser in the second. Even if the purchaser in the second contract is a separate legal entity, but owned by the seller in the first contract; it would not tantamount to a valid parallel *Salam* agreement. For example, 'A' has purchased 1000 bags of wheat by way of *Salam* from 'B' -

a joint stock company. 'B' has a subsidiary 'C', which is a separate legal entity but is fully owned by 'B'. 'A' cannot contract the parallel *Salam* with 'C'. However, if 'C' is not wholly owned by 'B', 'A' can contract parallel *Salam* with it, even if some share-holders are common between 'B' and 'C'.

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ISTISNA'

Istisna' is a sale transaction where a commodity is transacted before it comes into existence. It is an order to a manufacturer to manufacture a specific commodity for the purchaser. The manufacturer uses his own material to manufacture the required goods.

In *Istisna'*, price must be fixed with consent of all parties involved. All other necessary specifications of the commodity must also be fully settled.

Cancellation of contract:

After giving prior notice, either party can cancel the contract before the manufacturing party has begun its work. Once the work starts, the contract cannot be cancelled unilaterally.

Difference between *Istisna'* and *Salam*

	Istisna'	***Salam***
1.	The subject on which transaction of *Istisna'* is based, is always a thing which needs to be manufactured.	The subject can be anything that need manufacturing or not.
2.	The price in *Istisna'* does not necessarily need to be paid in full in advance. It is not even necessary to pay	The price has to be paid in full in advance.

	the full price at delivery. It can be deferred to any time according to the agreement of the parties. The payment may also be made in installments.	
3.	The time of delivery does not have to be fixed in *Istisna'*.	The time of delivery is an essential part of the sale.
4.	The contract can be cancelled before the manufacturer starts the work.	The contract cannot be cancelled unilaterally.

Difference between *Istisna'* and *Ijarah:*

	Istisna'	*Ijarah*
1.	The manufacturer either uses his own material and if it is not available with him, obtains it to make the ordered goods.	The material is provided by the customer and the manufacturer uses only his labor and skill meaning that his services will be hired for a specified fee paid to him.
2.	The purchaser has a right to reject the goods after inspection as *Shariah* permits somebody who purchases a thing not seen by him, to cancel the sale after seeing it. The right of rejection only exists if the goods do not conform to the specifications agreed upon between the parties at the time of contract.	Right of rejection of goods after inspection does not exist.

Time of delivery

As pointed out earlier, it is not necessary in *Istisna'* that the time of delivery is fixed. However, the purchaser may fix a maximum time for delivery which means that if the manufacturer delays the delivery after the appointed time, he will not be bound to accept the goods and to pay the price.

In order to ensure that the goods will be delivered within the specified period, some modern agreements of this nature contain a penal clause to the effect that in case the manufacturer delays the delivery after the appointed time, he shall be liable to a penalty which shall be calculated on daily basis. Can such a penal clause be inserted in a contract of *Istisna'* according to *Sharia*h? Although the classical jurists seem to be silent about this question while they discuss the contract of *Istisna'*, yet they have allowed a similar condition in the case of *Ijarah*. They say that if a person hires the services of a person to tailor his clothes, the fee may be variable according to the time of delivery. The hirer may say that he will pay Rs. 100/- in case the tailor prepares the clothes within one day and Rs. 80/- in case he prepares them after two days.

On the same analogy, the price in *Istisna'* may be tied up with the time of delivery, and it will be permissible if it is agreed between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount per day.

Istisna' as a mode of financing

Istisna' may be used to provide financing for house financing. If the client owns a land and seeks financing for the construction of a house, the financier may undertake to construct the house on the basis of an *Istisna'*. If the client does not own the land and wants to purchase that too, the financier can provide him with a constructed house on a specified piece of land. The financier does not have to construct the house himself. He can either enter into a parallel *Istisna'* with a third party or hire the services of a

contractor (other than the client). He must calculate his cost and fix the price of *Istisna'* with his client that allows him to make a reasonable profit over his cost. The payment of installments by the client may start right from the day when the contract of *Istisna'* is signed by the parties. In order to secure the payment of installments, the title deeds of the house or land, or any other property of the client may be kept by the financier as a security until the last installment is paid by the client. The financier will be responsible to strictly conform to the specifications in the agreement for the construction of the house. The cost of correcting any discrepancy would have to be borne by him.

Istisna' may also be used for similar projects like installation of an air conditioner plant in the client's factory, building a bridge or a highway.

The modern BOT (buy, operate and transfer) agreements may be formalized through an *Istisna'* agreement as well. So, if the government wants to build a highway, it may enter into an *Istisna'* contract with the builder. The price of *Istisna'* maybe the right of the builder to operate the highway and collect tolls for a specific period.

Uses of Istisna':

- House financing
- Financing of plant / factory / building.
- Booking of apartments
- BOT arrangements
- Construction of buildings and plants.

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ISTIJRAR

Istijrar means purchasing goods time to time in different quantities. In Islamic jurisprudence *Istijrar* is an agreement where a buyer purchases something from time to time; each time there is no offer or acceptance or bargain. There is one master agreement where all terms and conditions are finalized. There are two types of *Istijrar*:

- Whereby the price is determined after all transactions of purchase are complete.
- Whereby the price is determined in advance but the purchase is executed from time to time.

The first kind is relevant with the Islamic mode of financing. This kind is permissible with certain conditions.

1. In the case where the seller discloses the price of goods at the time of each transaction; the sale becomes valid only when the buyer possess the goods. The amount is paid after all transactions have been completed.

2. If the seller does not disclose each and every time to the buyer the price of the subject matter, but the contractors know that it is being sold on market value and the market value is specified and determined in such a manner that it does not vary and it does not lead to differences of the contractors.

3. If at the time of possession, the price of subject matter was unknown or contractors agree that whatever the price shall be, the sale will be executed. However, if there is significant difference in the market price and the agreed price, it may cause conflict. In such a case, at the time of possession, the sale will not be valid. However, at the time of settlement of the payment, the sale will be valid.

The validity will relate to the time of possession. Therefore the ownership of the buyer in the subject matter will be proved from the time of possession. After the payment of price the buyer's usage of the subject matter will be valid from the time of the possession.

As far as the use of *Istijrar* in Islamic banks is concerned, at present they are involved in four kinds of activities, namely *Murabahah, Ijarah, Mudarabah* and *Musharakah*. Out of these four, the concept of *Istijrar* can be applied to only the first three cases, due to the reason that *Istijrar* cannot be applied to borrowers of the bank. However, the same concept can however be applied to suppliers of the borrower.

However, *Istijrar* can work with suppliers of the borrower. In this case, the bank enters into a *Murabahah* with the suppliers on the basis of *Istijrar*. The bank enters into an A*greement to Purchase* with the suppliers (which are mainly trading companies) that it will purchase assets from them at a market price or at a predetermined discount from the market price. Whenever the bank has a new customer, it can purchase the assets from the suppliers on the basis of *Istijrar* and sell it onwards to the customer on the basis of *Murabahah*.

It might very well be probable that the bank might enter into a pseudo-*Istijrar* agreement with the suppliers rather than a true one. This is the case when the bank enters into an agreement with the customer that it is going to sell certain assets in a certain quantity to them within a specified time period. The customer may then purchase the assets from the

banks in tranches rather than at once and complete the whole purchase within the specified time period in order to complete the agreement.

The above type of *Istijrar* is referred to as *Istijrar* with Pre-agreed Sale due to the reason that the customer purchases a given amount of assets from the bank over a period of time but the price of the assets purchased is always known before the sale. Given the above, there is no difference of opinion between *Shariah* scholars as far as accepting this type of transaction as *Bai-Ta'ati* is concerned. However, the use of *Ta'ati* in case of a *Murabahah* transaction is not acceptable, as it leads indirectly to *Riba* in case the bank does not take possession of the assets before they are sold to the customer. Hence if *Ta'ati* is to be used in this case, then the only way to do it is that the bank should purchase the assets some time before selling it to the customer. This would ensure possession that is not just constructive but the bank would have title to the assets before they are sold to the customer.

Given that the above conditions are complied with to their full extent, *Istijrar* can be used in case of a *Murabahah*.

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IJARAH (LEASING)

Basic Rules

Transferring of usufruct not ownership
In leasing an owner transfers its usufruct to another person for an agreed period, at an agreed consideration.

Subject of lessee
Should be valuable, identified and quantified.

All consumable things cannot be leased out
The corpus of the leased property remains in the ownership of the seller, and only its usufruct is transferred to the lessee. Thus, anything, which cannot be used without consuming, cannot be leased out. For example money, wheat etc.

All liabilities of ownership is borne by lessor
As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor.

Period of lease
- The period of lease must be determined in clear terms.
- It is necessary for a valid lease that the leased asset is fully identified by the parties.

Lease for specific purpose

The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement. However, if no such purpose is specified in the agreement, the lessee can use it for whatever purpose it is used in the normal course.

Lessee as *Ameen*

- The lessee is liable to compensate the lessor for every harm to the leased asset caused by any misuse or negligence.
- The leased asset shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.

Lease of jointly owned property

- A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all joint owners according to the proportion of their respective shares in the property.
- A joint owner of a property can lease his proportionate share only to his co-sharer, and not to any other person.

Determination of Rental

- The rental must be determined at the time of contract for the whole period of lease.
- It is permissible that different amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of affecting a lease. If the rent for a subsequent phase of the lease period has not been determined or has been left at the option of the lessor, the lease is not valid.
- The determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules

of *Shariah*, if both parties agree to it, provided that all other conditions of a valid lease prescribed by the *Shariah* are fully adhered to.

- The lessor cannot increase the rent unilaterally, and any agreement to this effect is void.
- The rent or any part thereof may be payable in advance before the delivery of the asset to the lessee, but the amount so collected by the lessor shall remain with him as 'on account' payment and shall be adjusted towards the rent after its being due.
- The lease period shall commence from the date on which the leased asset has been delivered to the lessee.
- If the leased asset has totally lost the function for which it was leased, the contract will stand terminated.
- The rentals can be used on or benchmarked with some Index as well. In this case the ceiling and floor rentals can be identified for validity of lease.

Lease as a mode of financing

Lease is not originally a mode of financing. It is simply a transaction meant to transfer the usufruct of a property from one person to another for an agreed period against an agreed consideration. However, certain financial institutions have adopted leasing as a mode of financing instead of long term lending on the basis of interest.

This transaction of financial lease may be used for Islamic financing, subject to certain conditions. It is not sufficient for this purpose to substitute the name of 'interest' by the name of 'rent' and replace the name of 'mortgage' by the name of 'leased asset'. There must be a substantial difference between leasing and an interest-bearing loan. That will be possible only by following all the Islamic rules of leasing, some of which have been mentioned earlier.

To be more specific, some basic differences between the contemporary financial leasing and the actual leasing allowed by the *Shariah* are indicated below:

The commencement of lease

Unlike the contract of sale, the agreement of *Ijarah* can be effected for a future date. Hence, it is different from *Murabaha*.

In most cases of the 'financial lease' the lessor i.e. the financial institution purchases the asset through the lessee himself. The lessee purchases the asset on behalf of the lessor who pays its price to the supplier, either directly or through the lessee. In some lease agreements, the lease commences on the very day on which the price is paid by the lessor, irrespective of whether the lessee has effected payment to the supplier and taken delivery of the asset or not. It may mean that lessee's liability for the rent starts before the lessee takes delivery of the asset. This is not allowed in *Shariah*, because it amounts to charging rent on the money given to the customer, which is nothing but interest, pure and simple.

Rent should be charged after the delivery of the leased asset

The correct way, according to *Shariah*, is that the rent will be charged after the lessee has taken delivery of the asset, and not from the day the price has been paid. If the supplier has delayed the delivery after receiving the full price, the lessee should not be liable for the rent of the period of delay.

Different relations of the parties

It should be clearly understood that when the lessee himself has been entrusted with the purchase of the asset intended to be leased, there are two separate relations between the institution and the client, which come into operation one after the other. In the first instance, the client is an agent of the institution to purchase the asset on latter's behalf. At this stage, the relation between the parties is nothing more than the relation of a principal and his agent. The relation of lessor and lessee has not yet come into operation.

The second stage begins from the date when the client takes delivery from the supplier. At this stage, the relation of lessor and lessee comes to play its role. These two capacities of the parties should not be mixed up or confused with each other. During the first stage, the client cannot be held liable for the obligations of a lessee. In this period, he is responsible to carry out the functions of an agent only. But when the asset is delivered to him, he is liable to discharge his obligations as a lessee.

Difference between *Murabahah* and leasing:
In *Murabahah*, as mentioned earlier, actual sale should take place after the client takes delivery from the supplier, and the previous agreement of *Murabahah* is not enough for effecting the actual sale. Therefore, after taking possession of the asset as an agent, he is bound to give intimation to the institution, and make an offer for the purchase from him. The sale takes place after the institution accepts the offer.

The procedure in leasing is different, and a little shorter. Here the parties need not effect the lease contract after taking delivery. If the institution, while appointing the client its agent, has agreed to lease the asset with effect from the date of delivery, the lease will automatically start on that date without any additional procedure. There are two reasons for this difference between *Murabahah* and leasing:

a) It is a necessary condition for a valid sale that it should be affected instantly. Thus, a sale attributed to a future date is invalid in *Shariah*. But leasing can be attributed to a future date. Therefore, the previous agreement is not sufficient in the case of *Murabahah*, while it is quite enough in the case of leasing.
b) The basic principle of *Shariah* is that one cannot claim a profit or a fee for a property the risk of which was never borne by him. Applying this principle to *Murabahah*, the seller cannot claim a profit over a property, which never remained under his risk for a moment. Therefore, if the

previous agreement is held to be sufficient for affecting a sale between the client and the institution, the asset shall be transferred to the client simultaneously when he takes its possession, and the asset shall not come into the risk of the seller even for a moment. That is why the simultaneous transfer is not possible in *Murabahah*, and there should be a fresh offer and acceptance after the delivery.

In leasing, however, the asset remains under the risk and ownership of the lessor throughout the leasing period, because the ownership has not been transferred. Therefore, if the lease period begins right from the time when the client has taken delivery, it does not violate the principle mentioned above.

Expenses consequent to ownership

- As the lessor is the owner of the asset and he has purchased it from the supplier through his agent, he is liable to pay all the expenses incurred in the process of its purchase and its import to the country of the lessor for example expenses of freight and customs duty etc.
- He can, of course, include all these expenses in his cost and can take them into consideration while fixing the rentals, but as a matter of principle, he is liable to bear all these expenses as the owner of the asset. Any agreement to the contrary, as is found in the traditional financial leases, is not in conformity with *Shariah*.

Lessee as *Ameen*/Liability of the parties in case of loss to the asset

As mentioned in the basic principles of leasing, the lessee is responsible for any loss caused to the asset by his misuse or negligence. He can also be made liable to the wear and tear, which normally occurs during its use. But he cannot be made liable to a loss caused by the factors beyond his control. The agreements of the traditional 'financial lease' generally do not differentiate between the two situations. In a lease based on

the Islamic principles, both the situations should be dealt with separately.

Variable Rentals in Long Term Leases

In the long-term lease agreements, it is mostly not in the benefit of the lessor to fix one amount of rent for the whole period of lease, because the market conditions change from time to time. In this case, the lessor has two options:

(a) He can contract lease with a condition that the rent shall be increased according to a specified proportion (e.g. 5%) after a specified period (like one year).

(b) He can contract lease for a shorter period after which the parties can renew the lease at new terms and by mutual consent, with full liberty to each one of them to refuse the renewal, in which case the lessee is bound to vacate the leased property and return it back to the lessor.

These two options are available to the lessor according to the classical rules of Islamic Fiqh. However, some contemporary scholars have allowed, in long-term leases, to tie up the rental amount with a variable benchmark, which is so well known and well defined that it does not leave room for any dispute. For example, it is permissible according to them to provide in the lease contract that in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of same amount. Similarly it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. Therefore if there is an increase of 5% in the rate of inflation, it will result in an increase of 5% in the rent as well.

Based on the same principle, some Islamic banks use the rate of interest as a benchmark to determine the rental amounts. They want to earn the same profit through leasing as is earned by the conventional banks through advancing loans on the basis of interest. Therefore, they want to tie up the rentals with the rate of interest and instead of fixing a definite

amount of rental, they calculate the cost of purchasing the lease assets and want to earn through rentals an amount equal to the rate of interest. Therefore, the agreement provides that the rental will be equal to the rate of interest or to the rate of interest plus something. Since the rate of interest is variable, it cannot be determined for the whole lease period. Therefore, these contracts use the interest rate of a particular country (like LIBOR) as a benchmark for determining the periodical increase in the rent. This arrangement has been criticized on two grounds:

a) The first objection raised against it is that, by subjecting the rental payments to the rate of interest, the transaction is rendered akin to an interest based financing. This objection can be overcome by saying that, as fully discussed in the case of *Murabahah*, the rate of interest is used as a benchmark only. So far as other requirements of *Shariah* for a valid lease are properly fulfilled, the contract may use any benchmark for determining the amount of rental. The basic difference between an interest based financing and a valid lease does not lie in the amount to be paid to the financier or the lessor. The basic difference is that in the case of lease, the lessor assumes the full risk of the corpus of the leased asset. If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset looses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot claim the rent, while in the case of an interest-based financing, the financier is entitled to receive interest, even if the debtor did not at all benefit from the money borrowed. So far as this basic difference is maintained, (i.e. the lessor assumes the risk of the leased asset) the transaction cannot be categorized as an interest-bearing transaction, even though the amount of rent claimed from the lessee is equal to the rate of interest.

   It is thus clear that the use of the rate of interest merely as a benchmark does not render the contract invalid as an

interest - based transaction. It is, however, advisable at all times to avoid using interest even as a benchmark, so that an Islamic transaction is totally distinguished from an un-Islamic one, having no resemblance of interest whatsoever.

b) The second objection to this arrangement is that the variations of the rate of interest being unknown, the rental tied up with the rate of interest will imply *Jahalah* and *Gharar* which is not permissible in *Shariah*. It is one of the basic requirements of *Shariah* that the parties must know the consideration in every contract when they enter into it. The consideration in a transaction of lease is the rent charged from the lessee, and therefore it must be known to each party right at the beginning of the contract of lease. If we tie up the rental with the future rate of interest, which is unknown, the amount of rent will remain unknown as well. This is the *Jahalah* or *Gharar*, which renders the transaction invalid.

Responding to this objection, one may say that the *Jahalah* has been prohibited for two reasons:

- It may lead to dispute between the parties. This reason is not applicable here, because both parties have agreed with mutual consent upon a well-defined benchmark that will serve as a criterion for determining the rent, and whatever amount is determined, based on this benchmark, will be acceptable to both parties. Therefore, there is no question of any dispute between them.

- The second reason for the prohibition of *Jahalah* is that it renders the parties susceptible to an unforeseen loss. It is possible that the rate of interest, in a particular period, zooms up to an unexpected level in which case the lessee will suffer. It is equally possible that the rate of interest zooms down to an unexpected level, in which case the lessor may suffer. In order to meet the risks involved in

> such possibilities, it is suggested by some contemporary scholars that the relation between rent and the rate of interest is subjected to a limit or ceiling. For example, it may be provided in the base contract that the rental amount after a given period, will be changed according to the change in the rate of interest, but it will in no case be higher than 15% or lower than 5% of the previous monthly rent. It will mean that if the increase in the rate of interest is more than 15%, the rent will be increased only up to 15%. Conversely, if the decrease in the rate of interest is more than 5%, the rent will not be decreased to more than 5%.

In our opinion, this is the moderate view, which takes care of all the aspects involved in the issue.

Penalty for Late Payment of Rent

In some agreements of financial leases, a penalty is imposed on the lessee in case he delays the payment of rent after the due date. This penalty, if meant to add to the income of the lessor, is not warranted by the *Shariah*. The reason is that the rent after it becomes due, is a debt payable by the lessee, and is subject to all the rules prescribed for a debt. A monetary charge from a debtor for his late payment is exactly the *riba* prohibited by the Holy Quran. Therefore, the lessor cannot charge an additional amount in case the lessee delays payment of the rent.

Penalty of late payment is given to charity

In order to avoid the adverse consequences, an alternative may be resorted to. The lessee may be asked to undertake that, if he fails to pay rent on its due date, he will pay certain amount to a charity. For this purpose the financier/lessor may maintain a charity fund where such amounts may be credited and disbursed for charitable purposes, including advancing interest-free loans to the needy persons. The amount payable for charitable purposes by the lessee may vary according to the period of default and may be calculated

at per cent, per annum basis . The agreement of the lease may contain the following clause for this purpose:

"The Lessee hereby undertakes that, if he fails to pay rent at its due date, he shall pay an amount calculated at ....% p.a. to the charity Fund maintained by the Lessor which will be used by the Lessor exclusively for charitable purposes approved by the *Shariah* and shall in no case form part of the income of the Lessor."

This arrangement, though does not compensate the lessor for his opportunity cost of the period of default, yet it may serve as a strong deterrent for the lessee to pay the rent promptly.

Termination of Lease

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. In some agreements of the 'financial lease' it has been noticed that the lessor has been given an unrestricted power to terminate the lease unilaterally whenever he wishes, according to his sole judgment. This is again contrary to the principles of *Shariah*.

In some agreements of the 'financial lease' a condition has been found to the effect that in case of the termination of lease, even at the option of the lessor, the lessee shall pay the rent of the remaining lease period.

This condition is obviously against *Shariah* and the principles of equity and justice. The basic reason for inserting such conditions in the agreement of lease is that the main concept behind the agreement is to give an interest-bearing loan under the ostensible cover of lease. That is why every effort is made to avoid the logical consequences of the lease contract.

Naturally, such a condition cannot be acceptable to *Shariah*. The logical consequence of the termination of lease is that the lessor should take the asset back. The lessee should be asked to pay the rent as due up to the date of termination. If the termination has been effected due to the misuse or negligence on the part of the lessee, he can also be asked to compensate the lessor for the loss caused by such misuse or negligence. But he cannot be compelled to pay the rent of the remaining period.

Insurance of the assets
If the leased property is insured under the Islamic mode of *Takaful*, it should be at the expense of the lessor and not at the expense of the lessee, as is generally provided in the agreements of the current 'financial leases'.

The residual value of the leased asset
Another important feature of the modern 'financial leases' is that after the expiry of the lease period, the corpus of the leased asset is normally transferred to the lessee. As the lessor already recovers his cost along with an additional profit thereon, which is normally equal to the amount of interest which could have been earned on a loan of that amount advanced for that period, the lessor has no further interest in the leased asset. On the other hand, the lessee wants to retain the asset after the expiry of the leased period.

For these reasons, the leased asset is generally transferred to the lessee at the end of the lease, either free of any charge or at a nominal token price. In order to ensure that the asset will be transferred to the lessee, sometimes the lease contract has an express clause to this effect. Sometimes this condition is not mentioned in the contract expressly; however, it is understood between the parties that the title of the asset will be passed on to the lessee at the end of the lease term. This condition, whether it is express or implied, is not in accordance with the principles of *Shariah*. It is a well-settled rule of Islamic jurisprudence that one transaction cannot be

tied up with another transaction so as to make the former a pre-condition for the other. Here the transfer of the asset at the end has been made a necessary condition for the transaction of lease that is not allowed in *Shariah*.

The original position in *Shariah* is that the asset shall be the sole property of the lessor, and after the expiry of the lease period, the lessor shall be at liberty to take the asset back, or to renew the lease or to lease it out to another party, or sell it to the lessee or to any other person. The lessee cannot force him to sell it to him at a nominal price, nor can such a condition be imposed on the lessor in the lease agreement. But after the lease period expires, and the lessor wants to give the asset to the lessee as a gift or to sell it to him, he can do so by his free will.

However, some contemporary scholars, keeping in view the needs of the Islamic financial institutions have come up with an alternative. They say that the agreement of *Ijarah* itself should not contain a condition of gift or sale at the end of the lease period. However, the lessor may enter into a unilateral promise to sell the leased asset to the lessee at the end of the lease period. This promise will be binding on the lessor only. The principle, according to them, is that a unilateral promise to enter into a contract at a future date is allowed whereby the promisor is bound to fulfill the promise, but the promisee is not bound to enter into that contract . It means that he has an option to purchase, which he may or may not exercise. However, if he wants to exercise his option to purchase, the promisor cannot refuse it because he is bound by his promise. Therefore, these scholars suggest that the lessor, after entering into the lease agreement, can sign a separate unilateral promise whereby he undertakes that if the lessee has paid all the amounts of rentals and wants to purchase the asset at a specified mutually acceptable price, he will sell the leased asset to him for that price. Once the lessor signs this promise, he is bound to fulfill it and the lessee may exercise his option to purchase at the end of the period, if he has fully paid the amounts of rent according to the agreement of lease.

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IJARAH WA IQTINA (LEASING AND PROMISE TO GIFT)

In Islamic *Shariah*, it is allowed that instead of sale, the lessor signs a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent. This arrangement is called '*Ijarah wa iqtina*. It has been allowed by a large number of contemporary scholars and is widely acted upon by the Islamic banks and financial institutions. The validity of this arrangement is subject to two basic conditions:

a) The agreement of *Ijarah* itself should not be subjected to signing this promise of sale or gift but the promise should be recorded in a separate document.
b) The promise should be unilateral and binding on the promisor only. It should not be a bilateral promise binding on both parties because in this case it will be a full contract effected to a future date, which is not allowed in the case of sale or gift.

Sub-Lease

If the leased asset is used differently by different users, the lessee cannot sub-lease the leased asset except with the express permission of the lessor. If the lessor permits the lessee for subleasing, he may sub-lease it. If the rent claimed from the sub-lessee is equal to or less than the rent payable to the owner / original lessor, all the recognized schools of Islamic jurisprudence are unanimous on the permissibility of the sub lease. However, the opinions are different in case the

rent charged from the sub-lessee is higher than the rent payable to the owner. Imam Shafi and some other scholars allow it and hold that the sub lessor may enjoy the surplus received from the sub-lessee. This is the preferred view in the Hanbali School as well. On the other hand, Imam Abu Hanifah is of the view that the surplus received from the sub-lessee in this case is not permissible for the sub-lessor to keep and he will have to give that surplus in charity. However, if the sub-lessor has developed the leased property by adding something to it or has rented it in a currency different from the currency in which he himself pays rent to the owner/the original lessor, he can claim a higher rent from his sub-lessee and can enjoy the surplus.

Although the view of Imam Abu Hanifah is more precautious which should be acted upon to the best possible extent, in cases of need the view of Shafai and Hanbali schools may be followed because there is no express prohibition in the Holy Quran or in the *Sunnah* against the surplus claimed from the lessee. Ibn Qudamah has argued for the permissibility of surplus on forceful grounds.

Assigning of the Lease

The lessor can sell the leased property to a third party whereby the relation of lessor and lessee shall be established between the new owner and the lessee. However, the assigning of the lease itself (without assigning the ownership in the leased asset) for a monetary consideration is not permissible.

The difference between the two situations is that in the latter case the ownership of the asset is not transferred to the assignee, but he becomes entitled to receive the rent of the asset only. This kind of assignment is allowed in *Shariah* only where no monetary consideration is charged from the assignee for this assignment. For example, a lessor can assign his right to claim rent from the lessee to his son, or to his friend in the form of a gift. Similarly, he can assign this right

to any one of his creditors to set off his debt out of the rentals received by him. But if the lessor wants to sell this right for a fixed price, it is not permissible, because in this case the money (the amount of rentals) is sold for money, which is a transaction subject to the principle of equality. Otherwise it will be tantamount to a *riba* transaction, hence prohibited.

SECTION V

BANKING IN ISLAM

22

THE FEATURES OF A CONVENTIONAL BANK

The conventional banking, which is interest based, performs the following major activities:

1. Deposit creation
2. Financing (Refer to section IV)
3. Agency services
4. Issuing LGs
5. Advisory services
6. Other related services

We now would like to make a comparison of these activities with Islamic concept of banking:

Deposits (The liability side)

Deposit – *qard* (loan) not *amanah* (Trust)

The common misconception regarding "deposit" is that it is a form of *amanah* (security/trust). However, according to Shariah definition, deposit has more resemblance to *qard* (loan) than *amanah*. This conclusion is based on the fact that in Islam an item is termed as *amanah*, if it bears all the features of *amanah*. Deposits cannot be termed *amanah*, as they do not have two of its special features, i.e.

- *Amanah* cannot be used by the bank for its business or benefit.
- The bank cannot be liable in case of any damage or loss to the *amanah* resulting from circumstances beyond its control.

Whereas in banks, deposits are primarily placed to earn profit, which is only possible when the bank uses these deposits to invest in other business. Hence deposits do not fulfill the first condition of *amanah*, which says that it should not be used by the caretaker for his own business or benefit.

Secondly, the bank is held 100% responsible for these deposits in all circumstances even in case of loss or damage to the bank. This feature releases deposits from the ruling of *amanah* where the assets will not be returned in case of any damage to the asset resulting from circumstances beyond caretaker's control. According to this justification, all three kinds of deposit namely current accounts, fixed deposits and saving accounts are not *amanah*. They are all governed by *qard*.

One school of thought says that only fixed deposit and saving accounts fall under the laws of *qard* but current account is governed by *amanah*. However, this is also not correct because the bank is as much liable to current account holders as its PLS account holders and is called the "guarantor" in fiqh terminology. Due to this feature, current account is also governed by *qard*.

The depositors are not interested in terminology but the end-result of holding an account. Therefore if a bank does not offer security to the assets, the depositors under normal circumstance will never keep their assets at such a bank. Similarly if the depositors are told that the status of their account will that be of *amanah* and in case of any loss to the assets, without any negligence of the bank, will not be returned to them, not a single person would put his asset in

the bank. Therefore the bank provides the security to the assets, which the depositors themselves want.

We therefore conclude that the main intention of the depositors is not to put the assets in banks as *amanah*; rather as *qard* by having collateral security by appointing the bank as guarantor.

Example of Syedna Zubair bin Awwam (RA)

Hazrat Zubair bin Awwam (RA) was famous for his honesty and trustworthiness. Prominent people used to leave with him their properties in trust. Based on their needs they would also withdraw all or part of their properties. It has been reported in Al Bukhari and Tabaqaat-e-Ibn-e-Saad in respect of Hazrat Zubair bin Awwam (RA) that he would decline to accept such property as *amanah* (trust) but rather accepted them as *qard* (loan).

The reason for this action on his part was his fear that the property may be lost and it may be suspected that he was neglectful in its safekeeping. As such, he decided to consider it a loan so that the depositor felt more comfortable and his reputation remained intact. Another reason for it was that it could become possible for him to employ these funds for trading and earn profit out of them. The loan amount calculated at 2.2 million at the time of his death by his son Syedna Abdullah bin Zubair was specified as *qard* not *amanah*. He also used the term loan while instructing his son before his death "Son, dispose off my property to settle the loans".

Conclusion

From the above discussion, we come to the conclusion that all three forms of bank deposits are governed by the law of *qard* as a consequence of which the account holder may withdraw only the assets deposited. Any increase on it will be interest. It has already been discussed in the chapter of commercial

interest that if the purpose of the lender is business or security and not providing financial assistance, then to get an excess amount is also interest, which is prohibited in Islam just like usury.

It is also clear that there is a consensus of Muslim scholars on the point that the transactions in Fixed Deposit and Savings Account is prohibited because the bank pays excess to their account holders over their actual capital, which is interest. The Islamic Fiqh Academy Jeddah in their 2nd session has further endorsed such transactions as interest based transaction. Therefore it is illegal for a Muslim to keep their deposits in such accounts. As far as the current account is concerned, the bank does not pay any excess (interest) over the actual capital, therefore holding such an account is allowed.

To sum up, profit given on fixed deposit and savings accounts is interest and therefore prohibited. However if the banking system is based on Islamic principles, *Musharakah* can play a very important role. Therefore we will now discuss how the banks can operate on *Musharakah* basis. As we already know a bank has two sides, one where it receives deposits from customers which is called the liability side and the other where it advances finance to investors and businessmen which is called the asset side. Both sides can operate on *Musharakah* basis. As far as deposits are concerned, *Musharakah* is the only instrument in which money can be received from customers meaning that every depositor will become a partner in bank's business through their deposited money. However, for the asset or finance side, there are other instruments apart from *Musharakah* but since those instruments are not covered in our subject, we will stick to the operation of *Musharakah*. We will begin by the role of *Musharakah* in the deposits and its relevant laws and will then discuss the procedure of *Musharakah* in the finance side.

Role of the Bank as Agent :

A bank under Islamic Shariah can act as an agent (on Al-Wakalah basis) of the customer and can carry out the transaction on his behalf. Moreover it can charge agency fee for the services.

The agency fee can be charged in the following cases:

- Payment / receiving of cash on behalf of the customer
- Inward bill of collection
- Outward bill of collection
- LC opening and acceptance
- Collection of export bills / bills of exchange. In this case the undertaking or guarantee commission and take-up commission can be Islamized. Bank will charge an agency fee for accepting the bills, which is bought at face value.
- Underwriting & IPO services

Role of the Bank as Guarantor

The bank or financial institute gives a guarantee on behalf of its customer but according to Shariah, guarantee fee cannot be charged. Normally conventional banks charge fee for following guarantees:

- Letter of guarantee
- Shipping guarantee

Advisory Services

Most of the advisory services provided by the financial institutes can be carried out easily in compliance with Shariah as long as the nature of business is halal:

- Financial advisory services
- Privatization advisory services
- Equity placement

- Merger & acquisition advise
- Venture capital
- Trading (Capital market operations)
- Cash & portfolio management advice
- Brokerage services (Purchase & buying of share of companies involved in halal business, a fee could be charged for it).

Other allowed Islamic financial services & products

- Remittance
- Zakat deduction.
- Sale & purchase of foreign currency
- Sale & purchase of travelers checks (local & foreign currency)
- ATM services
- Electronic online transfer
- Telegraphic transfer (of cash)
- Demand draft
- Pay order
- Lockers & custodial services
- Syndicate funds arrangements services (non-interest or markup based) for some fee.
- Opening of bank account (current & non-interest or no-markup)
- Clearing facility
- Sales & purchase of shares/stock (of companies involved in halal activities)
- Collection of dividends
- Electronic banking window
- Telephone banking.

23

MUSHARAKAH IN BANK DEPOSITS

An important value of an Islamic society is mutual dealing. It also refers to deposits in banks. The operation of fixed deposits and savings account in Islamic banks will be different from conventional banks because the Islamic banks will be based on *Musharakah* (combination of *Shirkah* & *Mudarabah*) in which like conventional banks, people will invest in two ways:

1. Participation in setting up the bank like any other company by joint investment and the participants will be called the "shareholders". They will have a partnership *(Shirkah)* effected by a mutual contract since they have used their capital and deed on the bank; and

2. Participation by opening their account in fixed deposit and savings account and participants will be called the "account holders". These will not be the actual owner or shareholders of the bank – rather partners in profit only, meaning that they will have a contract of *Mudarabah*

The status of the bank or the shareholders will be that of a *Mudarib* and the account holders will be *Rubb-ul-mal*. The contract known as *Musharakah* will be a combination of *Shirkah* and *Mudarabah*. This is the reason why the profit ratio of depositors is less than the actual shareholders and the

depositors will not have any voting power or the right of management because they are not involved in the deed but has only supplied the capital. This kind of dual relationship is not uncommon in Islamic Fiqh. Therefore if the *Mudarib* (Bank or the shareholders) wants to merge his assets with the assets of depositor, it is allowed in which case he will be regarded as owner of half the assets and *Mudarib* of the other half. This has already been discussed at length in chapter 13 on *Musharakah*.

In the previous chapter, following facts have been established:

1. The actual status of deposits is debt and not amanah.
2. The excess paid on loan is interest, not profit.
3. If a bank is operating on Islamic principles, the bank and the depositor will have a partnership through a contract of *Shirkah* or *Mudarabah* in which case the depositor's capital will not be regarded as loan.
4. The shareholders will act as *Rubb-ul-mal* as well as *Mudarib*.
5. The depositors will only act as *Rubb-ul-mal*.
6. Fixed deposit and saving account will be converted into *Mudarabah* account where the distribution of profit for each partner will be determined in proportion to the actual profit accrued to the business and not according to a fixed ratio or in proportion to the capital invested by him. Fixing lump sum amount is not allowed or any rate of profit tied up with any investment.
7. The entire set up of the bank is on *Musharakah* basis where the relationship of the bank and shareholders is through partnership agreement (*Shirkah)* because they are participating in labor as well as investment and the relationship between the bank and depositors is only that of *Mudarabah* because they have only invested without participating in labor. Therefore this combination of *Shirkah* and *Mudarabah* is called *Musharakah* in modern terminology.

DISTRIBUTION OF PROFIT UNDER MUSHARAKAH AGREEMENT

The distribution of profit will be done according to the rules of *Musharakah.* Before we begin the summary of the distribution of profit, it is found appropriate to mention here that the conventional banks do not pay interest to current account holders. Therefore there is no need to convert the operation of current account into any Islamic mode of financing. However the distribution of profit to the rest of the partners and account holders will be made on the following rules governing *Musharakah*:

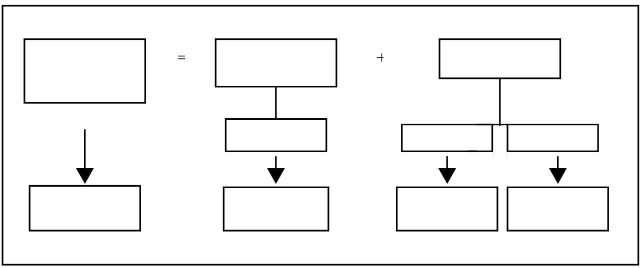
It is not a condition for the final distribution of profit that all assets are liquid – rather the profit and loss is calculated on the basis of evaluation of assets. In case of loss, each partner shall suffer the loss exactly according to the ratio of his investment and in case of profit; the profit will be distributed according to the agreed ratio between the partners. It should be taken into account that both parties are free to determine any ratio of profit of the bank as the manager (*Mudarib*), therefore it can be agreed mutually that *Rubb-ul-mal* will have a higher profit margin and *Mudarib* lower. However as a shareholding partner, the share of profit of the *Mudarib* cannot be less than the ratio of his investment since he is the sole provider of labor. Same rule will apply on the operation of Islamic Banks on the basis of *Musharakah*. The actual shareholders apart from being the manager are also shareholding partners; their ratio of profit cannot be less than their ratio of investment. However their ratio of profit as *Mudarib* can be determined at whatever rate they please.

The above may be explained in the following illustration:

Suppose the total investment of the bank is Rs.15 million in which the depositors have invested Rs.10 million on *Mudarabah* basis and the shareholders as *Mudarib* have invested Rs.5 million. This means that one third share of the total capital belongs to the shareholders and two third to the

depositors. The role of *Mudarib* in the $2/3^{rd}$ capital raised by depositors is played by the shareholders, therefore their ratio of profit as manager (*Mudarib*) can be agreed between themselves through mutual consent but their ratio of profit, as shareholders cannot be less than $1/3^{rd}$. If their share is agreed at less than $1/3^{rd}$, it would mean that the depositors' share has exceeded $2/3^{rd}$ although it has been established that they will not be managing the bank and their share of profit will not exceed their ratio of investment.

If it has been agreed in the above example that the shareholders as managing partners will get $1/3^{rd}$ of the profit and the rest $2/3^{rd}$ will be distributed equally between depositors and shareholders as per the Mudarabah contract between them, then if for eg. the profit amount is Rs.15 lacs then the shareholders will get its $1/3^{rd}$ i.e. Rs.5 lacs as the investor (*Rubb-ul-mal)* and half of the $2/3^{rd}$ profit i.e. Rs.5 lacs as the manager (*Mudarib*) whereas the other half of the $2/3^{rd}$ profit will go to the depositor as *Rubb-ul-mal*. The following table will clarify the shares of shareholders and depositors:



To sum up, the above procedure can be adopted to run the bank on the principles of *Musharakah*.

RUNNING MUSHARAKAH ACCOUNT ON THE BASIS OF DAILY PRODUCTS:

Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on upto the date of maturity, and the interest is calculated on the basis of daily products.

Can such an arrangement be possible under the *Musharakah* or *Mudarabah* modes of financing? Obviously, being a new phenomenon, no express answer to this question can be found in the classical works of Islamic Fiqh. However, keeping in view the basic principles of *Musharakah* the following procedure may be suggested for this purpose:

- A certain percentage of the actual profit must be allocated for the management.
- The remaining percentage of the profit must be allocated for the investors.
- The loss, if any, should be borne by the investors only in exact proportion of their respective investments.
- The average balance of the contributions made to the *Musharakah* account calculated on the basis of daily products shall be treated as the share capital of the financier.
- The profit accruing at the end of the term shall be calculated on daily product basis, and shall be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principle of the *Musharakah.* However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have

agreed to the principle that the profit accrued to the *Musharakah* portfolio at the end of the term will be divided based on the average capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the number of the days each investor has put his money into the business, which will determine his profit entitlement on daily product basis.

Some contemporary scholars do not allow this method of calculating profits on the ground that it is just a conjectural method, which does not reflect the actual profits really earned by a partner of the *Musharakah*. Because the business may have earned huge profits during a period when a particular investor had no money invested in the business at all, or had a very insignificant amount invested, still, he will be treated at par with other investors who had huge amounts invested in the business during that period. Conversely, the business may have suffered a great loss during a period when a particular investor had huge amounts invested in it. Still, he will pass on some of his loss to other investors who had no investment in that period or their size of investment was insignificant.

This argument can be refuted on the ground that it is not necessary in a *Musharakah* that a partner should earn profit on his own money only. Once a *Musharakah* pool comes into existence, all the participants, regardless of whether their money is or is not utilized in a particular transaction earn the profits accruing to the joint pool. This is particularly true of the Hanafi School, which does not deem it necessary for a valid *Musharakah* that the monetary contributions of the partners are mixed up together. It means that if 'A' has entered into a *Musharakah* contract with 'B', but has not yet disbursed his money into the joint pool, he will be still entitled to a share in the profit of the transactions effected by 'B' for the *Musharakah* through his own money. Although his entitlement to a share in the profit will be subject to the

disbursement of money undertaken by him, yet the fact remains that the profit of this particular transaction did not accrue to his money, because the money disbursed by him at a later stage may be used for another transaction. Suppose 'A' and 'B' entered into a *Musharakah* to conduct a business of Rs. 100,000/- They agreed that each one of them shall contribute Rs. 50,000/- and the profits will be distributed by them equally. 'A' did not yet invest his Rs. 50,000/- into the joint pool. 'B' found a profitable deal and purchased two air conditioners for the *Musharakah* for Rs. 50,000/- contributed by himself and sold them for Rs. 60,000/-, thus earning a profit of Rs. 10,000/-. 'A' contributed his share of Rs. 50,000/- after this deal. The partners purchased two refrigerators through this contribution which could not be sold at a greater price than Rs. 48000/- meaning thereby that this deal resulted in a loss of Rs. 2000/- Although the transaction effected by 'A's money brought loss of Rs. 2000/- while the profitable deal of air conditioners was financed entirely by '*B's* money in which 'A' had no contribution, yet 'A' will be entitled to a share in the profit of the first deal. The loss of Rs. 2000/- in the second deal will be set off from the profit of the first deal reducing the aggregate profit to Rs. 8000/-. This profit of Rs. 8000/- will be shared by both partners equally. It means that 'A' will get Rs. 4000/-, even though the transaction effected by his money has suffered a loss.

The reason is that once the parties enter into a *Musharakah* contract, all the subsequent transactions effected for *Musharakah* belong to the joint pool, regardless of whose individual money is utilized in them. Each partner is a party to each transaction by virtue of his entering into the contract of *Musharakah*.

A possible objection to the above explanation may be that in the above example, 'A' had undertaken to pay Rs. 50,000/- and it was known before hand that he would contribute a specified amount to the *Musharakah*. But in the proposed running account of *Musharakah* where the partners are

coming in and going out every day, nobody has undertaken to contribute any specific amount. Therefore, the capital contributed by each partner is unknown at the time of entering into *Musharakah*, which should render the *Musharakah* invalid.

The answer to the above objection is that the classical scholars of Islamic Fiqh have different views about whether it is necessary for a valid *Musharakah* that the capital is pre-known to the partners. The Hanafi scholars are unanimous on the point that it is not a pre-condition. Al-Kasani, the famous Hanafi jurist, writes:

According to our Hanafi School, it is not a condition for the validity of *Musharakah* that the amount of capital is known, while it is a condition according to Imam Shafi'i. Our argument is that Jahalah (uncertainty) in itself does not render a contract invalid, unless it leads to disputes. And the uncertainty in the capital at the time of *Musharakah* does not lead to disputes, because it is generally known when the commodities are purchased for the *Musharakah*, therefore it does not lead to uncertainty in the profit at the time of distribution." (Badai-us-sanai v.6 p.63)

It is, therefore, clear from the above that even if the amount of the capital is not known at the time of *Musharakah*, the contract is valid. The only condition is that it should not lead to the uncertainty in the profit at the time of distribution. Distribution of profit on daily product basis fulfills this condition.

It is true that the concept of a running *Musharakah* where the partners at times draw some amounts and at other times inject new money and the profits are calculated on daily products basis is not found in the classical books of Islamic Fiqh. But merely this fact cannot render a new arrangement invalid in Shariah, so far as it does not violate any basic principle of *Musharakah*. In the proposed system, all the

partners are treated at par. The profit of each partner is calculated on the basis of the period for which his money remained in the joint pool. There is no doubt in the fact that the aggregate profits accrued to the pool is generated by the joint utilization of different amounts contributed by the participants at different times. Therefore, if all of them agree with mutual consent to distribute the profits on daily products basis, there is no injunction of Shari'ah which makes it impermissible; rather, it is covered under the general guidelines given by the Holy Prophet ﷺ in his famous hadith, as follows:

"Muslims are bound by their mutual agreements unless they hold a permissible thing as prohibited or a prohibited thing as permissible."

If distribution on daily products basis is not accepted, it will mean that no partner can draw any amount nor can he inject new amounts to the joint pool. Similarly, nobody will be able to subscribe to the joint pool except at the particular dates of the commencement of a new term. This arrangement is totally impracticable on the deposit side of the banks and financial institutions where the accounts are debited and credited by the depositors many times a day. The rejection of the concept of the daily products will compel them to wait for months before they deposit their surplus money in a profitable account. This will hinder the utilization of savings for development of industry and trade, and will keep the wheel of financial activities jammed for long periods. There is no other solution for this problem except to apply the method of daily products for the calculation of profits, and since there is no specific injunction of Shari'ah against it, there is no reason why this method should not be adopted.

SECTION VI

APPLICATIONS OF ISLAMIC FINANCING

24

PROJECT FINANCING

The concept of *Musharakah* and *Mudarabah* is based on some basic principles. As long as these principles are fully complied with, the details of their application may vary from time to time. Let us have a look at these basic principles before touching the details:

1. Financing through *Musharakah* and *Mudarabah* does never mean the advancing of money. It means participation in the business and in the case of *Musharakah*, sharing in the assets of the business to the extent of the ratio of financing.

2. An investor/financier must share the loss incurred by the business to the extent of his financing.

3. The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment. However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.

4. The loss suffered by each partner must be exactly in the proportion of his investment.

Keeping in view these basic principles project financing is discussed below.

In the case of project financing, the traditional method of *Musharakah* or *Mudarabah* can be easily adopted. If the financier wants to finance the whole project, the form of *Mudarabah* can come into operation. If investment comes from both sides, the form of *Musharakah* can be adopted. In this case, if the management is the sole responsibility of one party, while the investment comes from both, a combination of *Musharakah* and *Mudarabah* can be brought into play according to the rules already discussed.

Since *Musharakah* or *Mudarabah* would have been effected from the very inception of the project, no problem with regard to the valuation of capital should arise. Similarly, the distribution of profits according to the normal accounting standards should not be difficult. However, if the financier wants to withdraw from the *Musharakah*, while the other party wants to continue the business, the latter can purchase the share of the former at an agreed price. In this way the financier may get back the amount he has invested along with a profit, if the business has earned a profit. The basis for determining the price of his share shall be discussed in detail later on (while discussing the financing of working capital).

On the other hand, the businessman can continue with his project, either on his own or by selling the first financier's share to some other person who can substitute the financier. Since financial institutions do not normally want to remain partner of a specific project for good, they can sell their share to other partners of the project as aforesaid. If the sale of the share on one time basis is not feasible for the lack of liquidity in the project, the share of the financier can be divided into smaller units and each unit can be sold after a suitable interval. Whenever a unit is sold, the share of the financier in the project is reduced to that extent, and when all the units are sold, the financier totally comes out of the project.

Financing of a single transaction

Musharakah and *Mudarabah* can be used more easily for financing a single transaction. Apart from fulfilling the day to day needs of small traders, these instruments can be employed for financing imports and exports. An importer can approach a financier to finance him for that single transaction of import alone on the basis of *Musharakah* or *Mudarabah*. The banks can also use these instruments for import financing. If the letter of credit has been opened without any margin, the form of *Mudarabah* can be adopted, and if the L/C is opened with some margin, the form of *Musharakah* or a combination of both will be relevant. After the imported goods are cleared from the port, their sale proceeds may be shared by the importer and the financier according to a pre-agreed ratio.

In this case, the ownership of the imported goods shall remain with the financier to the extent of the ratio of his investment. This *Musharakah* can be restricted to an agreed term, and if the imported goods are not sold in the market up to the expiry of the term, the importer may himself purchase the share of the financier, making himself the sole owner of the goods. However, the sale in this case should take place at the market rate or at a price agreed between the parties on the date of sale, and not at pre-agreed price at the time of entering into *Musharakah*. If the price is pre-agreed, the financier cannot compel the client / importer to purchase it.

Similarly, *Musharakah* will be even easier in the case of export financing. The exporter has a specific order from abroad. The price on which the goods will be exported is well known before hand, and the financier can easily calculate the expected profit. He may finance him on the basis of *Musharakah* or *Mudarabah*, and may share the amount of export bill on a pre-agreed percentage. In order to secure himself from any negligence on the part of the exporter, the

financier may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the L/C. In this case, if some discrepancies are found, the exporter alone shall be responsible, and the financier shall be immune from any loss due to such discrepancies, because it is caused by the negligence of the exporter. However, being a partner of the exporter, the financier will be liable to bear any loss, which may be caused due to any reason other than the negligence or misconduct of the exporter.

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WORKING CAPITAL FINANCING

Where finances are required for the working capital of a running business, the instrument of *Musharakah* may be used in the following manner:

1. ***The capital of the running business may be evaluated with mutual consent:*** The value of the business can be treated as the investment of the person who seeks finance, while the amount given by the financier can be treated as his share of investment. The *Musharakah* may be affected for a particular period, like one year or six months or less. Both the parties agree on a certain percentage of the profit to be given to the financier, which should not exceed the percentage of his investment, because he shall not work for the business. On the expiry of the term, all liquid and non-liquid assets of the business are again evaluated, and the profit may be distributed on the basis of this evaluation.

   Although, according to the traditional concept, the profit cannot be determined unless all the assets of the business are liquidated, yet the valuation of the assets can be treated as "constructive liquidation" with mutual consent of the parties, because there is no specific prohibition in *Shariah* against it. It can also mean that the working partner has purchased the share of the financier in the assets of the business, and the price of his share has been determined on the basis of valuation, keeping in view the

ratio of profit allocated for him according to the terms of *Musharakah*.

For example, the total value of the business of 'A' is 30 units. 'B' finances another 20 units, raising the total worth to 50 units; 40% having been contributed by 'B', and 60% by 'A'. It is agreed that 'B' shall get 20% of the actual profit. At the end of the term, the total worth of the business has increased to 100 units. Now, if the share of 'B' is purchased by 'A', he should have paid to him 40 units, because he owns 40% of the assets of the business. But in order to reflect the agreed ratio of profit in the price of his share, the formula of pricing will be different. Any increase in the value of the business shall be divided between the parties in the ratio of 20% and 80%, because this ratio was determined in the contract for the purpose of distribution of profit.

Since the increase in the value of the business is 50 units, these 50 units are divided at the ratio of 20:80, meaning thereby that 'B' will have earned 10 units. These 10 units will be added to his original 20 units, and the price of his share will be 30 units.

In the case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment, i.e., in the ratio of 40/60. Therefore, if the value of the business has decreased, in the above example, by 10 units reducing the total number of units to 40, the loss of 4 units shall be borne by 'B' (being 40% of the loss). These 4 units shall be deducted from his original 20 units, and the price of his share shall be determined as 16 units.

2. ***Sharing in the gross profit only:*** Financing on the basis of *Musharakah* according to the above procedure may be difficult in a business having a large number of fixed assets, particularly in a running industry, because the

valuation of all its assets and their depreciation or appreciation may create accounting problems giving rise to disputes. In such cases, *Musharakah* may be applied in another way.

The major difficulties in these cases arise in the calculation of indirect expenses, like depreciation of the machinery, salaries of the staff etc. In order to solve this problem, the parties may agree on the principle that, instead of net profit, the gross profit will be distributed between the parties, that is, the indirect expenses shall not be deducted from the distributable profit. It will mean that all the indirect expenses shall be borne by the industrialist voluntarily, and only direct expenses (like those of raw material, direct labor, electricity etc.) shall be borne by the *Musharakah*. But since the industrialist is offering his machinery, building and staff to the *Musharakah* voluntarily, the percentage of his profit may be increased to compensate him to some extent.

This arrangement may be justified on the ground that the clients of financial institutions do not restrict themselves to the operations for which they seek finance from the financial institutions. Their machinery and staff etc. is, therefore, engaged in some other business also which may not be subject to *Musharakah*, and in such a case the whole cost of these expenses cannot be imposed on the *Musharakah*.

Let us take a practical example. Suppose a ginning factory has a building worth Rs. 22 million, plant and machinery valuing Rs. 2 million and the staff is paid Rs. 50,000/- per month. The factory sought finance of Rs. 5,000,000/- from a bank on the basis of *Musharakah* for a term of one year. It means that after one year the *Musharakah* will be terminated, and the profits accrued up to that point will be distributed between the parties according to the agreed ratio. While determining the profit, all direct

expenses will be deducted from the income. The direct expenses may include the following:

1. The amount spent in purchasing raw material.
2. The wages of the labor directly involved in processing the raw material.
3. The expenses for electricity consumed in the process of ginning.
4. The bills for other services directly rendered for the *Musharakah*.

So far as the building, the machinery and the salary of other staff is concerned, it is obvious that they are not meant for the business of the *Musharakah* alone, because the *Musharakah* will terminate within one year, while the building and the machinery are purchased for a much longer term in which the ginning factory will use them for its own business which is not subject to this one-year *Musharakah*. Therefore, the whole cost of the building and the machinery cannot be borne by this short-term *Musharakah*. What can be done at the most is that the depreciation caused to the building and the machinery during the term of the *Musharakah* is included in its expenses.

But in practical terms, it will be very difficult to determine the cost of depreciation, and it may cause disputes also. Therefore, there are two practical ways to solve this problem.

In the first instance, the parties may agree that the *Musharakah* portfolio will pay an agreed rent to the client for the use of the machinery and the building owned by him. This rent will be paid to him from the *Musharakah* fund irrespective of profit or loss accruing to the business.

The second option is that, instead of paying rent to the client, the ratio of his profit is increased.

3. ***Running Musharakah Account on the Basis of Daily Products:*** Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

Keeping in view the basic principles of *Musharakah* the following procedure may be suggested for this purpose:

- A certain percentage of the actual profit must be allocated for the management.
- The remaining percentage of the profit must be allocated for the investors.
- The loss, if any, should be borne by the investors only in exact proportion of their respective investments.
- The average balance of the contributions made to the *Musharakah* account calculated on the basis of daily products shall be treated as the share capital of the financier.
- The profit accruing at the end of the term shall be calculated on daily product basis, and shall be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principle of the *Musharakah*. However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have agreed to the principle that the profit accrued to the *Musharakah* portfolio at the end of the term will be divided on the capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the number of the days each investor has put his money into the business, which will determine his profit entitlement on daily product basis.

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IMPORT FINANCING

Musharakah can be used for Import Financing as well. There are two types of bank charges on the letter of credit provided to the importer:

1. Service charges for opening an LC
2. Interest charged on LCs, which are not opened on full margin.

Collecting service charges for this purpose is allowed, but as interest cannot be charged in any case, experts have proposed two methods for financing LCs:

1. Based on *Musharakah / Mudarabah*
2. Based on *Murabahah*

Musharakah /Mudarabah:

This is the best substitute for opening the LC. The bank and the importer can make an agreement of *Mudarabah or Musharakah* before opening the LC.

If the LC is being opened at zero margin then an agreement of *Mudarabah* can be made, in which the bank will become *Rqb-ul-Maal* and the importer *Mudarib*. The bank will own the goods that are being imported and the profit will be distributed according to the agreement.

If the LC is being opened with a margin then a *Musharakah*

agreement can be made. The bank will pay the remaining amount and the goods that are being imported will be owned by both of them according to their share of investment.

The bank and the importer, with their mutual consent can also include a condition in the agreement, whereby; *Musharakah* or *Mudarabah* will end after a certain time period even if the goods are not sold. In such a case, the importer will purchase the bank's share at the market price.

Murabahah:

At present Islamic banks are using *Murabahah*, to finance LC. These banks themselves import the required goods and then sell these goods to the importer on *Murabahah* agreement.

Murabahah financing requires the bank and the importer to sign at least two agreements separately; one for the purchase of the goods, and the other for appointing the importer as the agent of the bank (agency agreement). Once these two agreements are signed, the importer can negotiate and finalize all terms and conditions with the exporter on behalf of the bank.

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EXPORT FINANCING

A bank plays two very important roles in Exports. It acts as a negotiating bank and charge a fee for this purpose, which is allowed in *Shariah*. Secondly it provides export-financing facility to the exporters and charge interest on this service. These services are of two types

1. Pre shipment financing
2. Post shipment financing

As interest cannot be charged in any case, experts have proposed certain methods for financing exports.

Pre Shipment Financing:

Pre shipment financing needs can be fulfilled by two methods

1. *Musharakah / Mudarabah*
2. *Murabahah*

Musharakah / Mudarabah:

The most appropriate method for financing exports is *Musharakah* or *Mudarbah*. Bank and exporter can make an agreement of *Mudarabah* provided that the exporter is not investing; other wise *Musharakah* agreement can be made. Agreement in such case will be easy, as cost and expected profit is known.

The exporter will manufacture or purchase goods and the

profit obtained by exporting it will be distributed between them according to the predefined ratio.

A problem that can be encountered by the bank is that if the exporter is not able to deliver the goods according to the terms and conditions of the importer, then the importer can refuse to accept the goods, and in this case exporter's bank will ultimately suffer. This problem can be rectified by including a condition in *Mudarabah* or *Musharakah* agreement that, if exporter violates the terms and conditions of import agreement then the Bank will not be responsible for any loss which arises due to this negligence. This condition is allowed in *Shariah* as the *Rabb-ul-mal* is not responsible for any loss that arises due to the negligence of *Mudarib*.

Murabahah

Murabahah is being used in many Islamic Banks for export financing. Banks purchases goods that are to be exported at price that is less than the price agreed between the exporter and the importer. It then exports goods at the original price and thus earns profit.

Murabahah financing requires bank and exporter to sign at least two agreements separately, one for the purchase of goods and the other for appointing the exporter as the agent of the bank (that is agency agreement). Once these two agreements are signed, the exporter can negotiate and finalize all the terms and conditions with the importer on behalf of the bank.

Post Shipment Financing:

Post shipment finance is similar to the discounting of the bill of exchange. Its alternate *Shariah* compliant procedure is discussed below:

The exporter with the bill of exchange can appoint the bank as his agent to collect receivable on his behalf. The bank can charge a fee for this service and can provide interest free loan

to the exporter, which is equal to the amount of the bill, and the exporter will give his consent to the bank that it can keep the amount received from the bill as a payment of the loan.

Here two processes are separated, and thus two agreements will be made. One will authorize the bank to collect the loan on his behalf as an agent, for which he will charge a particular fee. The second agreement will provide interest free loan to the exporter, and authorize the bank for keeping the amount received through bill as a payment for loan.

These agreements are correct and allowed according to *Shariah* because collecting fee for service and giving interest free loan is permissible

SECTION VII

ISLAMIC INVESTMENT

28

SECURITIZATION

Securitization means issuing certificates of ownership against an investment pool or business enterprise. This chapter discusses the issues, problems and rules in issuing such certificates with respect to the "nature" of investment pool. Basic guidelines are also provided on the negotiability and sale of these certificates in the secondary markets.

Securitization of *Musharakah*

Musharakah is a mode of financing which can be securitized easily, especially, in the case of big projects where huge amounts are required which a limited number of people cannot afford to subscribe. Every subscriber can be given a *Musharakah* certificate, which represents his proportionate ownership in the assets of the *Musharakah*, and after the project is started by acquiring substantial non-liquid assets, these *Musharakah* certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. However, trading in these certificates is not allowed when all the assets of the *Musharakah* are still in liquid form (i.e. in the shape of cash or receivables or advances due from others).

For proper understanding of this point, it must be noted that subscribing to a *Musharakah* is different from advancing a loan. A bond issued to evidence a loan has nothing to do with the actual business undertaken with the borrowed money.

The bond stands for a loan repayable to the holder in any case, and mostly with interest. The *Musharakah* certificate, on the contrary, represents the direct pro rata ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. For example, one hundred certificates, having a value of Rs. one million each, have been issued. It means that the total worth of the project is Rs. 100 million. If nothing has been purchased by this money, every certificate will represent Rs. one million. In this case, this certificate cannot be sold in the market except at par value, because if one certificate is sold for more than Rs.one million, it will mean that Rs. one million are being sold in exchange for more than Rs. one million, which is not allowed in *Shariah*, because where money is exchanged for money, both must be equal. Any excess at either side is *Riba*.

However, when the subscribed money is employed in purchasing non-liquid assets like land, building, machinery, raw material, furniture etc. the *Musharakah* certificates will represent the holders' proportionate ownership in these assets. Thus, in the above example, one certificate will stand for one hundredth share in these assets. In this case it will be allowed by the *Shariah* to sell these certificates in the secondary market for any price agreed upon between the parties which may be more than the face value of the certificate. Since the subject matter of the sale is a share in the tangible assets and not in money alone, therefore the certificate may be taken as any other commodity which can be sold with profit or at a loss.

In most cases, the assets of the project are a mixture of liquid and non-liquid assets. This comes to happen when the working partner has converted a part of the subscribed money into fixed assets or raw material, while rest of the money is still liquid. Or, the project, after converting all its money into non-liquid assets may have sold some of them

and has acquired their sale proceeds in the form of money. In some cases the price of its sales may have become due on its customers but may have not yet been received. These receivable amounts, being a debt, are also treated as liquid money. The question arises about the rule of *Shariah* in a situation where the assets of the project are a mixture of liquid and non-liquid assets, whether the *Musharakah* certificates of such a project can be traded in? The opinions of the contemporary Muslim jurists are different on this point. According to the traditional Shafi school, this type of certificate cannot be sold. Their classic view is that whenever there is a combination of liquid and non-liquid assets, it cannot be sold unless the non-liquid part of the business is separated and sold independently.

The Hanafi school, however, is of the opinion that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in combination, in which case money will be taken as sold at an equal amount and the excess will be taken as the price of the non-liquid assets owned by the business.

Suppose, the *Musharakah* project contains 40% non-liquid assets i.e. machinery, fixtures etc. and 60% liquid assets, i.e. cash and receivables. Now, each *Musharakah* certificate having the face value of Rs.100/- represents Rs. 60/- worth of liquid assets, and Rs.40/- worth of non-liquid assets. This certificate may be sold at any price more than Rs.60. If it is sold at Rs. 110/- it will mean that Rs. 60 of the price are against Rs. 60/- contained in the certificate and Rs.50/- is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of Rs.60/- or less, because in the case of Rs. 60/- it will not set off the amount of Rs. 60, let alone the other assets.

According to the Hanafi view, no specific proportion of non-liquid assets in the whole is prescribed. Therefore, even if the

non-liquid assets represent less than 50% in the whole, its trading according to the above formula is allowed.

However, most of the contemporary scholars, including those of Shafi school, have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50%.

Therefore, for a valid trading of the *Musharakah* certificates acceptable to all schools, it is necessary that the portfolio of *Musharakah* consists of non-liquid assets valuing more than 50% of its total worth. However, if Hanafi view is adopted, trading will be allowed even if the non-liquid assets are less than 50% but the size of the non-liquid assets should not be negligible.

Securitization of *Murabahah*

Murabahah is a transaction, which cannot be securitized for creating a negotiable instrument to be sold and purchased in secondary market. The reason is obvious. If the purchaser/client in a *Murabahah* transaction signs a paper to evidence his indebtedness towards the seller/financier, the paper will represent a monetary debt receivable from him. In other words, it represents money payable by him. Therefore transfer of this paper to a third party will mean transfer of money. It has already been explained that where money is exchanged for money (in the same currency) the transfer must be at par value. It cannot be sold or purchased at a lower or a higher price. Therefore, the paper representing a monetary obligation arising out of a *Murabahah* transaction cannot create a negotiable instrument. If the paper is transferred, it must be at par value. However, if there is a mixed portfolio consisting of a number of transactions like *Musharakah*, leasing and *Murabahah,* then this portfolio may issue negotiable certificates subject to certain conditions.

Securitization of *Ijarah*

The arrangement of *Ijarah* has a good potential of securitization, which may help create a secondary market for the financiers on the basis of *Ijarah*. Since the lessor in *Ijarah* owns the leased assets, he can sell the asset, in whole or in part, to a third party who may purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.

Therefore, if the lessor, after entering into *Ijarah*, wishes to recover his cost of purchase of the asset with a profit thereon, he can sell the leased asset wholly or partly either to one party or to a number of individuals. In the latter case, the purchase of a proportion of the asset by each individual may be evidenced by a certificate, which may be called '*Ijarah* certificate'. This certificate will represent the holder's proportionate ownership in the leased asset and he will assume the rights and obligations of the owner/lessor to that extent. Since the assets is already leased to the lessee, lease will continue with the new owners, each one of the holders of this certificate will have the right to enjoy a part of the rent according to his proportion of ownership in the asset. Similarly he will also assume the obligations of the lessor to the extent of his ownership. Therefore, in the case of total destruction of the asset, he will suffer the loss to the extent of his ownership. These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded freely in the market and can serve as an instrument easily convertible into cash. Thus they may help in solving the problems of liquidity management faced by the Islamic banks and financial institutions.

It should be remembered, however, that the certificate must represent ownership of an undivided part of the asset with all its rights and obligations. Misunderstanding this basic concept, some quarters tried to issue *Ijarah* certificates representing the holder's right to claim certain amount of the rental only without assigning to him any kind of ownership

in the asset. It means that the holder of such a certificate has no relation with the leased asset at all. His only right is to share the rentals received from the lessee. This type of securitization is not allowed in *Shariah*. As explained earlier in this chapter, the rent after being due is a debt payable by the lessee. The debt or any security representing debt only is not a negotiable instrument in *Shariah*, because trading in such an instrument amounts to trade in money or in monetary obligation which is not allowed, except on the basis of equality, and if the equality of value is observed while trading in such instruments, the very purpose of securitization is defeated. Therefore, this type of *Ijarah* certificates cannot serve the purpose of creating a secondary market.

It is, therefore, necessary that the *Ijarah* certificates are designed to represent real ownership of the leased assets, and not only a right to receive rent.

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ISLAMIC INVESTMENT FUNDS

The term 'Islamic Investment Fund' means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profit in strict conformity with the precepts of Islamic Shariah. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profit actually earned by the Fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name, but their validity in terms of Shariah, will always be subject to two basic conditions:

1. Instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Fund. Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund. If the Fund earns huge profits, the return on their subscription will increase to that proportion. However, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by the negligence or mismanagement, in which case the management, and not the Fund, will be liable to compensate it.

2. The amounts so pooled together must be invested in a business acceptable to Shariah. It means that not only the

channels of investment, but also the terms agreed with them must conform to the Islamic principles.

Keeping these basic requisites in view, the Islamic Investment Funds may accommodate a variety of modes of investment, which are discussed here briefly.

Equity Fund

In an equity or mutual fund (unit trust) the amounts are invested in the shares of joint stock companies. The profits are mainly derived through the capital gains by purchasing the shares and selling them when their prices are increased. Profits are also earned through dividends distributed by the relevant companies.

From this angle, dealing in equity shares can be acceptable in Shari'ah subject to the following conditions:

1. The main business of the company does not violate Shariah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shariah, eg. companies manufacturing, selling or offering liquor, pork, haram meat, or involved in gambling, night club activities, pornography, prostitution, or involved in the business of hire purchase or interest etc.

2. If the main business of these companies is halal, like automobiles, textile, etc. but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the share holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.

3. If some income from interest-bearing accounts or non-Halal activities is included in the income of the company, the proportion of such income should not exceed 5% of the total income. If it exceeds 5%, it is not permissible to invest in that company. However, if it does not exceed 5%, it must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity. Moreover, the company's total short term and long term investment in non-permissible business should not exceed 30% of the company's total market capitalization.

   It may be questioned "What is the basic rationale of this limitation of 5%?" Infact, there is no specific basis derived from the Holy Quran or Sunnah for the 5% rule of non halal (impermissible) income. However, this is only the collective outcome (consensus) or ijtihad of contemporary Shariah Scholars. To explain this consensus of their ruling, we shall have to go back to the origin or basis of company on Shariah perspective. As mentioned in the books and research papers of Islamic jurists, companies come under the ruling of Shirkatul Ainan. But if the rule of partnership is truly applied in a company, there is no possibility for any kind of impermissible activity or income. Because every shareholder of a company is a *sharik* (partner) of the company, and every *sharik*, according to the Islamic jurisprudence, is an agent of the other partners in matters of joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the shareholder to the company to carry on its business in whatever manner the management deems fit. If it is known to the shareholder that the company is involved in an un-Islamic transaction, and he continues to hold the shares of that company, it means that he has authorized the management to proceed with that un-Islamic transaction. In this case, he will not only be responsible for giving his consent to an un-

Islamic transaction, but that transaction will also be rightfully attributed to himself, because the management of the company is working under his tacit authorization.

However, a large number of Shariah Scholars say that Joint Stock Company is basically different from a simple partnership. In partnership, all the policy decisions are taken through the consensus of all partners, and each one of them has a veto power with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, the majority takes the policy decisions in a joint stock company. Being composed of a large number of shareholders, a company cannot give a veto power to each shareholder. The opinions of individual shareholders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every shareholder in his individual capacity. If a shareholder raises an objection against a particular transaction in an Annual General Meeting, but his objection is overruled by the majority, it will not be fair to conclude that he has given his consent to that transaction in his individual capacity, especially when he intends to refrain from the income resulting from that transaction.

Therefore, if a company is engaged in a halal (permissible) business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, then it cannot be said that he has approved the transaction of interest and hence that transaction should not be attributed to him.

In short, the matter of traditional partnership is different from the partnership of company in this aspect. Therefore if a very small amount of income is earned through these means despite of his disapproval, then his trade in shares would be permissible with the condition that, he shall have to purify that proportion of income by giving it to charity. Now a question could be raised as to what extent or what limit that income would be forgone. Definitely, this matter could not be left on decisions or opinions of lay men, therefore, it was resolved through the consensus of proficient Shariah Scholars that the limit of impermissible income should not exceed 5% of the total income.

4. The leverage or debt to equity ratio of the company should not exceed 30%. To explain the rationale behind this condition, it should be kept in mind that, such companies sometimes borrow money from financial institutions that are mostly based on interest. Here again the aforementioned principle applies i.e. if a shareholder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him.

   Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but, this sinful act does not render the whole business of the borrower as Haram (impermissible). It is explained in the conventional books of Islamic jurisprudence that the contract of loan is among those, that are called "Uqood Ghair Muawadha" (Non compensatory contracts), therefore, no void condition such as condition of interest can be stipulated. However, if such a condition has been stipulated, the condition itself is void, but it will not invalidate the contract. Since, the contract remains valid despite of void condition, the borrowed amount would be permissible to use and it

would be recognized as owned by the borrower. Hence, anything purchased in exchange for that money would not be unlawful. However, the responsibility of committing the sinful act of borrowing on interest rests on the person who willfully indulges in such a transaction but this does not render his entire business as unlawful. But it should also be remembered that the extent of investment in shares of companies, that involve borrowing should be limited. Can this limit be the same as the 5% limit that is applied to interest income? No, because in this case this activity does not affect the income of the company, it is less severe than interest based income, therefore, Shariah scholars and Islamic jurists extended the limit (from 5% which is limit of interest/impermissible income) to 30%. The basis of 30% is that the 30% is less than one third ($1/3^{rd}$) of the total asset of the company and one third has been considered abundant by the following Hadith of the Holy prophet (SAW) "One third is big or abundant" (Tirmizy). Hence whatever is less than one third, would be insignificant. Therefore to avoid the majority or abundance specified in the hadith, such limit is fixed at less than one third of the total asset of the company.

5. The shares of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the share represents money only and the money cannot be traded in except at par.

   What should be the exact proportion of illiquid assets of a company for warranting the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of illiquid assets must be 51% in the least. They argue that if such assets are less than 50%, then most of the assets are

in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle:

The majority deserves to be treated as the whole thing.
Some other scholars are of the view that even if the illiquid asset of a company is 33%, its shares can be treated as negotiable. The basis of this view is a well-known Hadith that means "One third is big or abundant" (Tirmizy).

They say that according to the Hadith one-third illiquid assets will be considered as sufficient or abundant for this purpose.
The third view (of the scholars of the sub continent of Pakistan and India) is based on the Hanafi jurisprudence. The principle of the Hanafi School is that whenever an asset is a combination of liquid and illiquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:

1. The illiquid part of the combination must not be in insignificant quantity. It means that it should be in a considerable proportion.

2. The price of the combination should be more than the value of the liquid amount contained therein. For example, if a share of 100 dollars represents 75 dollars, plus some fixed assets, the price of the share must be more than 75 dollars. In this case, if the price of the share is fixed at 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the balance of 30 dollars is in exchange of the fixed assets. Conversely, if the price of that share is fixed at 70 dollars, it will not be allowed, because the 75 dollars owned by the share are in this case against an amount which is less than 75. This kind of exchange falls within the definition of 'riba' and is not allowed. Similarly, if the price of the share, in the above example, is fixed at 75 dollars, it will not be permissible, because if we presume that 75 dollars of the price are against 75 dollars owned by the share, no part of

the price can be attributed to the fixed assets owned by the share. Therefore, some part of the price (75 dollars) must be presumed to be in exchange of the fixed assets of the share. In this case, the remaining amount will not be adequate for being the price of 75 dollars. For this reason the transaction will not be valid. However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where the price of a share goes lower than its liquid assets.

Among the three different views mentioned above, the most conservative view is the first one. Therefore, nowadays that has been adopted by the majority of Shariah boards of Islamic mutual funds or in screening of the Islamic stocks methodology.

Subject to aforesaid conditions, the purchase and sale of shares is permissible in Shariah. An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in shari'ah as partners inter se. All the subscription amounts will form a joint pool and will be invested in purchasing the shares of different companies. The profits can accrue either through dividends distributed by the relevant companies or through the appreciation in the prices of the shares. In the first case i.e. where the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of interest earned by the company, must be given in charity. The contemporary Islamic Funds have termed this process as 'purification'.

Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price of the share may reflect an element of interest included in the assets of the company. The method of purification adopted by Dow Jones Islamic market Index and Islmiqstocks.com are in favor of this view.

As we have discussed above for the negotiability of the share, it is essential for the share or securities that they represent more than 55% illiquid assets. If a mutual fund has 10% cash and 90% shares, we shall have to see how much of these shares represent fixed assets. Fixed assets include land, equipment, machinery and leased assets. If these shares represent more than 55% of fixed or illiquid assets, such shares or Musharkah certificates of mutual fund can be negotiated at other than par value as well.

Sale of option short sale, future sale and forward sale where some principles of Shariah are lacking are not permissible.

Management of the fund:
The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as mudaribs for the subscribers. In this case, a certain percentage of the annual profit accrued to the Fund may be determined as the reward of the management, meaning thereby that the management will get its share only if the fund has earned some profit. If there is no profit in the fund, the management will deserve nothing. The share of the management will increase with the increase of profits.

The second option for the management is to act as an agent for the subscribers. In this case, the management may be given a pre-agreed fee for its services. This fee may be fixed in lump sum or as a monthly or annual remuneration. According to the contemporary Shariah scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will get 2% or 3% of the net asset value of the fund at the end of every financial year.

However, it is necessary in Shariah to determine any one of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund the basis on which the fees of the management

will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

Ijarah Fund

Another type of Islamic Fund may be an Ijarah fund. Ijarah means leasing the detailed rules of which have already been discussed in chapter 23 this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund, which is distributed pro rata to the subscribers. Each subscriber is given a certificate to evidence his proportionate ownership in the leased assets and to ensure his entitlement to the pro rata share in the income. These certificates may preferably be called '*sukuk*' - a term recognized in the traditional Islamic jurisprudence. Since these *sukuk* represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these *sukuk* replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these *sukuk* certificates will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of *Shariah* which substantially differ from the terms and conditions used in the agreements of conventional financial leases. The points of difference are explained in detail in the third chapter of this book. However, some basic principles are summarized here:

1. The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.
2. The leased assets must be of a nature that their *halal* (permissible) use is possible.
3. The lessor must undertake all the responsibilities consequent to the ownership of the assets.
4. The rental must be fixed and known to the parties right at the beginning of the contract.

In this type of the fund, the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of Mudarabah, because Mudarabah, according to them, is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali School, Mudarabah can be effected in services and leases also. This view has been preferred by a number of contemporary scholars.

Commodity Fund

Another possible type of Islamic Funds may be a commodity fund. In the fund of this type the subscription amounts are used in purchasing different commodities for the purpose of their resale. The profits generated by the sales are the income of the fund, which is distributed pro rata among the subscribers.

In order to make this fund acceptable to *Shariah*, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The seller must own the commodity at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in *Shariah*.

2. Forward sales are not allowed except in the case of *Salam* and *Istisna* (For their full details, see chapters 17 & 20 respectively).
3. The commodities must be *halal*. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.
4. The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser).
5. The price of the commodity must be fixed and known to the parties. Any price, which is uncertain or is tied up with an uncertain event, renders the sale invalid.

In view of the above and similar other conditions, more fully described in the previous chapters of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, specially in the futures commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of Shariah, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

Murabaha Fund

'Murabaha' is a specific kind of sale where the commodities are sold on a cost-plus basis. The contemporary Islamic banks and financial institutions as a mode of financing have adopted this kind of sale. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason is that in the case of murabaha, as undertaken by the present financial

institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. Therefore, the portfolio of murabaha does not own any tangible assets. It comprises either cash or the receivable debts, Therefore, the units of the fund represent either the money or the receivable debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

Bai-Al-Dain

Here comes the question whether or not bai-al-dain is allowed in Shariah. Dain means 'debt' and Bai means sale. Bai-al-dain, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bills of exchange, it is termed in Shariah as Bai-al-dain. The traditional Muslim jurists (fuqah) are unanimous on the point that bai-al-dain with discount is not allowed in Shariah. The overwhelming majority of the contemporary Muslim scholars are of the same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of Shafai school wherein it is held that the sale of debt is allowed, but they did not pay attention to the fact that the Shafai jurists have allowed it only in a case where a debt is sold at its par value.

In fact, the prohibition of bai-al-dain is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same

denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shariah.

Some scholars argue that the permissibility of bai-al-dain is restricted to a case where the debt is created through the sale

of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as the sale of a commodity. The argument, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer owned by the seller. What the seller owns is nothing other than money. Therefore if he sells the debt, it is no more than the sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity.

That is why the overwhelming majority of the contemporary scholars have not accepted this view. The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Shariah scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of bai-al-dain unanimously without a single dissent.

Mixed Fund

Another type of Islamic Fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51% while the liquidity and debts are less than 50% the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50%, its units cannot be traded according to the majority of the contemporary scholars. In this case the Fund must be a closed-end Fund.

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THE PRINCIPLE OF LIMITED LIABILITY

By Justice Mohammad Taqi Usmani

The concept of 'limited liability' has now become an inseparable ingredient of the large-scale enterprises of trade and industry throughout the modern world, including the Muslim countries. The present chapter aims to explain this concept and evaluate it from the *Shariah* point of view in order to know whether or not this principle is acceptable in a pure Islamic economy.

The limited liability in the modern economic and legal terminology is a condition under which a partner or a shareholder of a business secures himself from bearing a loss greater than the amount he has invested in a company or partnership with limited liability. If the business incurs a loss, the maximum a shareholder can suffer is that he may lose his entire original investment. But the loss cannot extend to his personal assets, and if the assets of the company are not sufficient to discharge all its liabilities, the creditors cannot claim the remaining part of their receivables from the personal assets of the shareholders.

Although the concept of 'limited liability' was, in some countries applied to the partnership also, yet, it was most commonly applied to the companies and corporate bodies. Rather, it will be truer, perhaps, to say that the concept of 'limited liability' originally emerged with the emergence of the corporate bodies and joint stock companies. The basic purpose of the introduction of this principle was to attract the

maximum number of investors to the large-scale joint ventures and to assure them that their personal fortunes will not be at stake if they wish to invest their savings in such a joint enterprise. In the practice of modern trade, the concept proved itself to be a vital force to mobilize large amounts of capital from a wide range of investors.

No doubt, the concept of 'limited liability' is beneficial to the shareholders of a company. But, at the same time, it may be injurious to its creditors. If the liabilities of a limited company exceed its assets, the company becomes insolvent and is consequently liquidated, the creditors may lose a considerable amount of their claims, because they can only receive the liquidated value of the assets of the company, and have no recourse to its shareholders for the rest of their claims. Even the directors of the company who may be responsible for such an unfortunate situation cannot be held responsible for satisfying the claims of the creditors. It is this aspect of the concept of 'limited liability' which requires consideration and research from the *Shariah* viewpoint.

Although the concept of 'limited liability' in the context of the modern commercial practice is a new concept and finds no express mention as such in the original sources of Islamic Fiqh, yet the *Shariah* viewpoint about it can be sought in the principles laid down by the Holy Quran, the *Sunnah* of the Holy Prophet ﷺ and the Islamic jurisprudence. This exercise requires some sort of *ijtihad* carried out by the persons qualified for it. This *ijtihad* should preferably be undertaken by the *Shariah* scholars at a collective level, yet, as a pre-requisite, there should be some individual effort, which may serve as a basis for the collective exercise.

As a humble student of *Shariah,* this author have been considering the issue since long, and what is going to be presented in this article should not be treated as a final verdict on this subject, nor an absolute opinion on the point. It is the outcome of initial thinking on the subject, and the

purpose of this article is to provide a foundation for further research.

The question of 'limited liability' it can be said, is closely related to the concept of juridical personality of the modern corporate bodies. According to this concept, a joint-stock company in itself enjoys the status of a separate entity as distinguished from the individual entities of its shareholders. The separate entity as a fictive person has legal personality and may thus sue and be sued, may make contracts, may hold property in its name, and has the legal status of a natural person in all its transactions entered into in the capacity of a juridical person.

The basic question, it is believed, is whether the concept of a 'juridical person' is acceptable in *Shariah* or not. Once the concept of 'juridical person' is accepted and it is admitted that, despite its fictive nature, a juridical person can be treated as a natural person in respect of the legal consequences of the transactions made in its name, we will have to accept the concept of 'limited liability' which will follow as a logical result of the former concept. The reason is obvious. If a real person i.e. a human being dies insolvent, his creditors have no claim except to the extent of the assets he has left behind. If his liabilities exceed his assets, the creditors will certainly suffer, no remedy being left for them after the death of the indebted person.

Now, if we accept that a company, in its capacity of a juridical person, has the rights and obligations similar to those of a natural person, the same principle will apply to an insolvent company. A company, after becoming insolvent, is bound to be liquidated: and the liquidation of a company corresponds to the death of a person, because a company after its liquidation cannot exist any more. If the creditors of a real person can suffer, when he dies insolvent, the creditors of a juridical person may suffer too, when its legal life comes to an end by its liquidation.

Therefore, the basic question is whether or not the concept of 'juridical person' is acceptable to *Shariah*.

Although the idea of a juridical person, as envisaged by the modern economic and legal systems has not been dealt with in the Islamic Fiqh, yet there are certain precedents wherefrom the basic concept of a juridical person may be derived by inference.

1. *Waqf*

The first precedent is that of a *Waqf*. A *Waqf* is a legal and religious institution wherein a person dedicates some of his properties for a religious or a charitable purpose. The properties, after being declared as *Waqf*, no longer remain in the ownership of the donor. The beneficiaries of a *Waqf* can benefit from the corpus or the proceeds of the dedicated property, but they are not its owners. Its ownership vests in Allah Almighty alone.

It seems that the Muslim jurists have treated the *Waqf* as a separate legal entity and have ascribed to it some characteristics similar to those of a natural person. This will be clear from two rulings given by the *fuqaha* (Muslim jurists) in respect of *Waqf*.

Firstly, if a property is purchased with the income of a *Waqf*, the purchased property cannot become a part of the *Waqf* automatically. Rather, the jurists say, the property so purchased shall be treated, as a property owned by the *Waqf*. It clearly means that a *Waqf*, like a natural person, can own a property.

Secondly, the jurists have clearly mentioned that the money given to a mosque as donation does not form part of the *Waqf*, but it passes to the ownership of the mosque.

Here again the mosque is accepted to be an owner of money. Some jurists of the Maliki School have expressly mentioned this principle also. They have stated that a mosque is capable

of being the owner of something. This capability of the mosque, according to them, is constructive, while the capability enjoyed by a human being is physical.

Another renowned Maliki jurist, namely, Ahmad Al-Dardir, validates a bequest made in favor of a mosque, and gives the reason that a mosque can own properties. Not only this, he extends the principle to an inn and a bridge also, provided that they are *Waqf*.

It is clear from these examples that the Muslim jurists have accepted that a *Waqf* can own properties. Obviously, a *Waqf* is not a human being, yet they have treated it as a human being in the matter of ownership. Once its ownership is established, it will logically follow that it can sell and purchase, may become a debtor and a creditor and can sue and be sued, and thus all the characteristics of a 'juridical person' can be attributed to it.

2. Baitul-Mal

Another example of 'juridical person' found in our classic literature of *Fiqh* is that of the *Baitul-mal* (the exchequer of an Islamic state). Being public property, all the citizens of an Islamic state have some beneficial right over the *Baitul-mal*, yet, nobody can claim to be its owner. Still, the *Baitul-mal* has some rights and obligations. Imam Al-Sarakhsi, the well-known Hanafi jurist, says in his work "Al-Mabsut": "The *Baitul-mal* has some rights and obligations, which may possibly be undetermined."

At another place the same author says: "If the head of an Islamic state needs money to give salaries to his army, but he finds no money in the *Kharaj* department of the *Baitul-mal* (wherefrom the salaries are generally given) he can give salaries from the *sadaqah* (*Zakah*) department, but the amount so taken from the *sadaqah* department shall be deemed to be a debt on the *Kharaj* department".

It follows from this that not only the *Baitul-mal*, but also the different departments therein can borrow and advance loans to each other. The liability of these loans does not lie on the head of state, but on the concerned department of *Baitul-mal.* It means that each department of *Baitul-mal* is a separate entity and in that capacity it can advance and borrow money, may be treated a debtor or a creditor, and thus can sue and be sued in the same manner as a juridical person does. It means that the *Fuqaha* of Islam have accepted the concept of juridical person in respect of *Baitul-mal*.

3. Joint Stock

Another example very much close to the concept of 'juridical person' in a joint stock company is found in the *Fiqh* of Imam Shafai. According to a settled principle of Shafai School, if more than one person run their business in partner-ship, where their assets are mixed with each other, the *Zakah* will be levied on each of them individually, but it will be payable on their joint-stock as a whole, so much so that even if one of them does not own the amount of the *nisab*, but the combined value of the total assets exceeds the prescribed limit of the *nisab*, *zakah* will be payable on the whole joint-stock including the share of the former, and thus the person whose share is less than the *nisab* shall also contribute to the levy in proportion to his ownership in the total assets, whereas he was not subject to the levy of *zakah*, had it been levied on each person in his individual capacity.

The same principle, which is called the principle of '*Khultah-al-Shuyu*' is more forcefully applied to the levy of *Zakah* on the livestock. Consequently, a person sometimes has to pay more *Zakah* than he was liable to in his individual capacity, and sometimes he has to pay less than that. That is why the Holy Prophet ﷺ has said: 'The separate assets should not be joined together nor the joint assets should be separated in order to reduce the amount of *Zakah* levied on them'.

This principle of '*Khultah-al-Shuyu*' which is also accepted to some extent by the Maliki and Hanbali schools with some variance in details, has a basic concept of a juridical person underlying it. It is not the individual, according to this principle, who is liable to *Zakah*. It is the 'joint-stock' that has been made subject to the levy. It means that the 'joint-stock' has been treated a separate entity, and the obligation of *Zakah* has been diverted towards this entity which is very close to the concept of a 'juridical person', though it is not exactly the same.

4. Inheritance under debt

The fourth example is the property left by a deceased person whose liabilities exceed the value of all the property left by him. For the purpose of brevity we can refer to it as 'inheritance under debt'.

According to the jurists, this property is neither owned by the deceased, because he is no more alive, nor is it owned by his heirs, for the debts on the deceased have a preferential right over the property as compared to the rights of the heirs. It is not even owned by the creditors, because the settlement has not yet taken place. They have their claims over it, but it is not their property unless it is actually divided between them. Being property of nobody, it has its own existence and it can be termed a legal entity. The heirs of the deceased or his nominated executor will look after the property as managers, but they are not the owners. If the process of the settlement of debt requires some expenses, the same will be met by the property itself.

Looked at from this angle, this 'inheritance under debt' has its own entity which may sell and purchase, becomes debtor and creditor, and has the characteristics very much similar to those of a 'juridical person.' Not only this, the liability of this 'juridical person' is certainly limited to its existing assets. If the assets do not suffice to settle all the debts, there is no remedy left with its creditors to sue anybody, including the heirs of the deceased, for the rest of their claims.

These are some instances where the Muslim jurists have affirmed a legal entity, similar to that of a juridical person. These examples would show that the concept of 'juridical person' is not totally foreign to the Islamic jurisprudence, and if the juridical entity of a joint-stock company is accepted on the basis of these precedents, no serious objection is likely to be raised against it.

As mentioned earlier, the question of limited liability of a company is closely related to the concept of a 'juridical person'. If a 'juridical person' can be treated a natural person in its rights and obligations, then, every person is liable only to the limit of the assets he owns, and in case he dies insolvent no other person can bear the burden of his remaining liabilities, however closely related to him he may be. On this analogy the limited liability of a joint-stock company may be justified.

The limited liability of the master of a slave

Here I would like to cite another example with advantage, which is the closest example to the limited liability of a joint-stock company. The example relates to a period of our past history when slavery was in vogue, and the slaves were treated as the property of their masters and were freely traded in. Although the institution of slavery with reference to our age is something past and closed, yet the legal principles laid down by our jurists while dealing with various questions pertaining to the trade of slaves are still beneficial to a student of Islamic jurisprudence, and we can avail of those principles while seeking solutions to our modern problems and in this respect, it is believed that this example is the most relevant to the question at issue. The slaves in those days were of two kinds. The first kind was of those who were not permitted by their masters to enter into any commercial transaction. A slave of this kind was called '*Qinn*'. But there was another kind of slaves who were allowed by their masters to trade. A slave of this kind was called *Abde Mazoon* in Arabic. The initial capital for the purpose of trade was

given to such a slave by his master, but he was free to enter into all the commercial transactions. The capital invested by him totally belonged to his master. The income would also vest in him, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off by the cash and the stock present in the hands of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his price. However, if their claims would not be satisfied even after selling the slave, and the slave would die in that state of indebtedness, the creditors could not approach his master for the rest of their claims.

Here, the master was actually the owner of the whole business, the slave being merely an intermediary tool to carry out the business transactions. The slave owned nothing from the business. Still, the liability of the master was limited to the capital he invested including the value of the slave. After the death of the slave, the creditors could not have a claim over the personal assets of the master.

This is the nearest example found in the Islamic *Fiqh*, which is very much similar to the limited liability of the share holders of a company, which can be justified on the same analogy.

On the basis of these five precedents, it seems that the concepts of a juridical person and that of limited liability do not contravene any injunction of Islam. But at the same time, it should be emphasized, that the concept of 'limited liability' should not be allowed to work for cheating people and escaping the natural liabilities consequent to a profitable trade. So, the concept could be restricted, to the public companies only who issue their shares to the general public and the number of whose shareholders is so large that each one of them cannot be held responsible for the day-to-day affairs of the business and for the debts exceeding the assets.

As for the private companies or the partnerships, the concept of limited liability should not be applied to them, because, practically, each one of their shareholders and partners can easily acquire knowledge of the day-to-day affairs of the business and should be held responsible for all its liabilities.

There may be an exception for the sleeping partners or the shareholders of a private company who do not take part in the business practically and their liability may be limited as per agreement between the partners.

If the sleeping partners have a limited liability under this agreement, it means, in terms of Islamic jurisprudence, that they have not allowed the working partners to incur debts exceeding the value of the assets of the business. In this case, if the debts of the business increase from the specified limit, it will be the sole responsibility of the working partners who have exceeded the limit.

The upshot of the foregoing discussion is that the concept of limited liability can be justified, from the *Shariah* viewpoint, in the public joint-stock companies and those corporate bodies only who issues their shares to general public. The concept may also be applied to the sleeping partners of a firm and to the shareholders of a private company who take no active part in the business management. But the liability of the active partners in a partnership and active shareholders of a private company should always be unlimited.

At the end, we should again recall what has been pointed out at the outset. The issue of limited liability, being a modern issue, which requires a collective effort to find out its solution in the light of *Shariah*, the above discussion should not be deemed to be a final verdict on the subject. This is only the outcome of an initial thinking, which always remains subject to further study and research.

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